PETITION FOR WRIT OF CERTIORARI

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IN THE

Supreme Court of the United States

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON,

Petitioner,

—v.—

ANDREW A. HYMAN,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether a state court judgment holding a corporate fiduciary liable for the inherently willful misappropriation and exploitation of corporate assets for personal gain, without any additional finding of "intent," is dischargeable in bankruptcy (as appears to be the law in the First, Fifth and Seventh Circuits), or is within the purview of the "fiduciary defalcation" exception to discharge of Bankruptcy Code § 523(a)(4) (as appears to be the law in the Fourth, Sixth, Eighth and Ninth Circuits)?*

The Second Circuit, citing the "persistent confusion" and "debate among the Circuits," opted to join the former group and held such a debt dischargeable.

2. Whether the express findings of a state court that a corporate officer and director has breached his fiduciary duty by "co-opting [a corporate] enterprise for . . . his own personal enrichment," by . . . "exploiting the [corporations'] assets" and by "misappropriat[ing their] . . . tangible assets and goodwill" for personal gain, are sufficient, under principles of collateral estoppel, held applicable to Bankruptcy Court proceedings in *Grogan v. Garner*, 498 U.S. 279, 284 n. 11, 111 S. Ct. 654 (1991), to establish a "defalcation while acting in a fiduciary capacity" under Section 523(a)(4) of the Bankruptcy Code?

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* The Ninth Circuit is unique. Reflecting California law it has excluded corporate officers from fiduciary status. *In re Cantrell*, 329 F.3d 1119 (9th Cir. 2003). *But cf., F.D.I.C. v. Jackson*, 133 F.3d 694 (9th Cir. 1998) (applying Arizona law, negligence claim against corporate director under Bankruptcy Code § 523(a)(4) upheld).

The Second Circuit declined to apply collateral estoppel in these circumstances, concluding that issues unique to the Bankruptcy Code were not necessarily decided by the state court, effectively rendering collateral estoppel inapplicable in Bankruptcy Court proceedings involving the dischargeability of state court judgments holding corporate officers and directors liable for self-dealing.

PARTIES

The parties to this proceeding are:

1. Petitioner G. Hallett Denton, as Executor of the Estate of George W. Denton.

2. Respondent Andrew A. Hyman, a Chapter 7 Bankruptcy Debtor.

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OPINIONS AND ORDERS BELOW

The Opinion of the United States Court of Appeals for the Second Circuit (1a-19a) is reported at 502 F.3d 61 (2d Cir. 2007). The Opinion and Order of the United States District Court for the Southern District of New York (20a- 38a) is reported at 335 B.R. 32 (S.D.N.Y. 2005). The Decision of the United States Bankruptcy Court for the Southern District of New York (39a- 81a) is reported at 320 B.R. 493 (Bankr. S.D.N.Y. 2005).

The Decision of the Surrogate's Court, Westchester County, dated December 31, 2002, and its Decree, dated April 23, 2003, are not reported and are annexed, respectively at 84a- 99a and 100a-105a. The unanimous affirmance of the Appellate Division, Second Department (106a-109a) is reported at 6 A.D.3d 531, 774 N.Y.S.2d 424 (2d Dep't 2004), and the two denials of further appeals by the New York Court of Appeals (110a-111a, 112a-113a) are reported at 3 N.Y.3d 656, 782 N.Y.S.2d 695 (2004) and 5 N.Y.3d 714, 806 N.Y.S.2d 165 (2005).

JURISDICTION

The Judgment of the United States Court of Appeals for the Second Circuit sought to be reviewed was entered on September 6, 2007. On September 20, 2007, Petitioner timely filed his Petition for Rehearing and Rehearing En Banc, which was denied by Order of the United States Court of Appeals for the Second Circuit entered on October 23, 2007 (82a-83a). The jurisdiction of

this Court is invoked pursuant to 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

This case involves the provisions of the Bankruptcy Code, 11 U.S.C. § 523(a)(4), Article IV, § 1 of the U.S. Constitution and 28 U.S.C. § 1738, as follows:

> A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> (4) for fraud or *defalcation while acting in a fiduciary capacity*, embezzlement, or larceny; 11 U.S.C. § 523(a)(4) (emphasis added);
>
> Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State, And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof. U.S. Const. Art. IV § 1; and
>
> Such Acts, records and judicial proceedings or copies thereof, so authenticated, shall have the same full faith and credit in every court within the United States and its Territories and Possessions as they have by law or usage in the courts of such State, Territory or Possession from which they are taken. 28 U.S.C. § 1738

STATEMENT OF THE CASE

Petitioner ("Creditor") is the Executor of the Estate of his late father, George W. Denton ("Decedent"). Prior to his death in February 1989, Decedent and Respondent Andrew A. Hyman ("Debtor") were equal shareholders in three corporations[1] which Decedent and Debtor successfully operated as a unified enterprise (85a). Their success was based upon Denton-Hyman's marketing, through NPS and NPA, of Denton-Hyman's agents as pension consultants who, after obtaining entree to potential clients by offering pension design and administration services, could then sell insurance and mutual funds for which Denton-Hyman would be paid commissions (88a-89a).

When Decedent died in February 1989, Debtor, the Corporations' sole surviving officer and director, continued to exploit NPS and NPA to generate profits solely for himself (86a, 90a), while continuing to subsidize NPS and NPA with Denton-Hyman funds (90a, 93a).

When it became clear that Debtor was never going to pay for these assets, in March 1994, Creditor commenced a proceeding in the New York Surrogate's Court. Following a nine-day trial, the Surrogate found Debtor and his wholly-owned Hyman Agency liable for profits diverted as a result of his multiple breaches of fiduciary duty. Specifically, the Surrogate found that:

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[1] Denton-Hyman Agency, Inc. ("Denton-Hyman"), National Pension Service, Inc. ("NPS") and National Pension Actuaries ("NPA") (collectively, the "Corporations").

(a) "[a]s a 50% shareholder, officer and director of Denton-Hyman, NPS and NPA, Hyman [Debtor] owed a fiduciary duty to those corporations" which he violated by "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency [his 100% owned corporation] and for his own personal enrichment" (92a);

(b) "that Hyman [Debtor] exploited the assets of NPS and NPA to obtain profits for himself" (90a); and

(c) that "his actions constituted a misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA" (92a-93a).

The Surrogate rejected the Debtor's contentions that he was only operating the Corporations in good faith for the purpose of "preserving" and "maximizing" the stream of overriding commissions due Denton-Hyman[2] to repay debt which had been incurred by the parties in their operation of the enterprise prior to Decedent's death (the "Denton-Hyman Debt") (91a-92a).[3] With regard to Debtor's defenses that Creditor had "consented to and acquiesced" in his actions, the Surrogate found:

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[2] Denton-Hyman received overriding commissions on life insurance policies written prior to Decedent's death for nine years following the sale of each policy.

[3] Debtor and Creditor were jointly and severally liable for repayment of this debt, as Debtor and Decedent had personally guaranteed its repayment.

> . . . them unpersuasive and wholly unsupported by even a sympathetic reading of the testimony and evidence adduced at trial

(88a, 98a), and "dismissed" [them] . . . in their entirety." (*Id.*)

Following Debtor's bankruptcy filing,[4] the Appellate Division, Second Department, unanimously affirmed, holding that:

> . . . the evidence presented at trial established that the appellant Andrew A. Hyman [Debtor] breached his fiduciary duty to the [Corporations]. Accordingly, we discern no basis in the record to disturb the Surrogate's Court's credibility determination (108a).

The New York Court of Appeals twice rejected further appellate review (110a-113a).

Despite the fact that these issues were actually litigated in the state courts and necessarily resolved against Debtor, the Bankruptcy Court declined to accord collateral estoppel effect to the Surrogate's findings when Petitioner sought to have Debtor's debt declared nondischargeable under Bankruptcy Code § 523(a)(4),[5] as a "defalcation while acting in a fiduciary capacity." The Bankruptcy Court ignored the Surrogate's explicit findings in favor of its own more chari-

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[4] Debtor filed his petition under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the Southern District of New York on January 29, 2003, and his case was converted to a Chapter 7 case on July 6, 2004.

[5] The Bankruptcy Court had jurisdiction of Creditor's adversary proceeding to declare Debtor's debt nondischargeable under 28 U.S.C. §§ 1334 and 157.

table view of the facts[6]—a determination which it plainly was not entitled to make under the doctrine of collateral estoppel and the Full Faith and Credit Clause.

The Bankruptcy Court also rejected (albeit *sub silencio*) Creditor's contention that, under the Second Circuit's prior decision in *In re Hammond*, 98 F.2d 703 (2d Cir.), *cert. denied*, 305 U.S. 646 (1938), where a corporate fiduciary has been adjudicated to have breached his duty of loyalty to his corporation, no "conscious wrongdoing" need be shown.[7]

The District Court endorsed the Bankruptcy Court's conclusion that Creditor had failed to show that Debtor had done anything wrongful in operating the enterprise and declined to apply collateral estoppel to the state court's findings.

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[6] Included in this view was the erroneous assumption that Debtor contributed to the repayment of the Denton-Hyman Debt by his continued operation of the Corporations (46a, 69a). It is undisputed that Debtor never used any of the income derived from his continued operation of the enterprise for this purpose. The debts were paid entirely from Denton-Hyman overrides and other Denton-Hyman funds (which belonged 50% to Creditor), while Debtor diverted 100% of the profits through the Hyman Agency (115a-116a, 118a, 119a-120a).

[7] The debtor in *Hammond* was found liable for profits made on the sale of stock purchased with personal funds to enable the corporation to obtain access to valuable patents; the corporation was unable to do so, but benefitted from the purchase. The Second Circuit rejected the debtor's claim that his debt should be discharged because his actions were innocent because "animated by a desire to . . . benefit [the corporation] and he "had no intention of despoiling his cestui." 98 F.2d at 705.

The District Court also rejected Creditor's contention that *In re Hammond* was controlling. Directly contrary to the state court's findings, it concluded that "Debtor's conduct throughout was fully consistent with a good faith effort to preserve the business for the [parties'] mutual benefit" (34a).[8]

In affirming, the Second Circuit once again considered Debtor's claim of "good faith" and accepted, as evidence thereof, the Bankruptcy and District Courts' assumption that Debtor had contributed to repayment of the Denton-Hyman Debt. Recognizing "persistent confusion" (15a) and "debate among the Circuits" (10a), it concluded that the majority require "some level of wrongful conduct" in order to find a "defalcation" under Bankruptcy Code § 523(a)(4) (13a)[9]. Accordingly, the Second Circuit imposed a "scienter" requirement on the fiduciary defalcation exception, citing *In re Baylis*, 313 F.3d 9 (1st Cir. 2002), and declined to give collateral estoppel effect to the state court's findings. In the Second Circuit's view, the Surrogate "had neither the ability nor the incentive to apply [this standard]" (17a), which is not required under state law in corporate fiduciary self-dealing cases.

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[8] Like the Bankruptcy Court, the District Court predicated this conclusion on the erroneous assumption that Debtor had retired the Denton-Hyman Debt using profits of the Hyman Agency (25a, 34a).

[9] An erroneous conclusion given the Sixth Circuit's holding in *In re Johnson*, 691 F.2d 249 (6th Cir. 1982), described below.

REASONS FOR GRANTING THE PETITION

I. This Court Should Resolve the "Debate Among the Circuits" (10a) and "Persistent Confusion" (15a) as to Whether the Fiduciary Defalcation Exception to Dischargeability Under Bankruptcy Code § 523(a)(4) Requires Affirmative Findings of "Intent" or "Scienter" in Corporate Officer and Director Self-Dealing Cases, Findings Not Generally Required by State Law. A Uniform National Standard Eliminating These Non-Statutory Requirements From the Bankruptcy Code Would Effectively Enhance Common Law Remedies in Such Cases

The Second Circuit describes at some length the "debate" and "confusion" now prevailing in the Federal Circuit Courts of Appeal with respect to the fiduciary defalcation exception to dischargeability (10a-14a). On its face, the statute excepts from dischargeability in bankruptcy debts resulting from a "defalcation while acting in a fiduciary capacity." Bankruptcy Code § 523(a)(4). The application of that seemingly simple concept is anything but.

The Second Circuit's decision conflicts with those Circuits which apply an objective standard in such cases, holding that a finding of subjective wrongful intent is not required to satisfy the statutory standard of defalcation, provided only

that the debtor breached his fiduciary duty. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) ("Negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient."); *In re Hemmeter*, 242 F.3d 1186, 1190 (9th Cir. 2001) ("Even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations."); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997) ("Defalcation includes the innocent default of a fiduciary who fails to account fully for money received.").

The Sixth Circuit,[10] although having nominally asserted that a defalcation cannot be predicated on "mere negligence," has applied an objective standard in assessing the conduct of a fiduciary, holding that "creating a debt by breaching a fiduciary duty is a sufficiently bad act to invoke [§ 523(a)(4)'s predecessor] even without [proof of] a subjective mental state evidencing intent to breach a known fiduciary duty or bad faith in doing so." *In re Johnson*, 691 F.2d 249, 256 (6th Cir. 1982) (involving a trustee, not a corporate fiduciary).

This view applies with special force where, as here, a corporate fiduciary has been found liable for misappropriating corporate property for his personal benefit. *In re Hammond*, 98 F.2d 703 (2d Cir.), *cert. denied*, 305 U.S. 646 (1938); *see also In re Uwimana*, *supra*; *In re Cochrane*,

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[10] In an unreported decision the Sixth Circuit has also ruled that a debt resulting from the breach of a fiduciary duty by a corporate officer not involving the misappropriation of corporate assets is dischargeable. *In re Sullivan*, 19 Fed. Appx. 180 (6th Cir. 2001).

supra; *In re Johnson*, *supra*. As the Sixth Circuit observed in *Johnson*, "the requisite 'badness,' to conform with the spirit of the bankruptcy laws, is supplied by an individual's special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching these duties." 691 F.2d at 256. Nothing more should be required.

Those Circuits taking a contrary view are not unanimous in their articulation of the applicable standard. The Fifth Circuit has held that a "willful neglect" of a debtor's fiduciary duty must be shown to establish a defalcation under § 523(a)(4), which it has characterized as essentially a "recklessness standard." *In re Schwager*, 121 F.3d 177, 184-85 (5th Cir. 1997). The Seventh Circuit, although holding that a "mere negligent" breach of fiduciary duty is insufficient, *see Meyer v. Rigdon*, 36 F.3d 1375, 1384-85 (7th Cir. 1994), does not appear to have settled on the "something more" that is required to establish defalcation—whether it be a willful disregard of that duty, "recklessness" or otherwise.[11]

The First Circuit, whose position the Second Circuit has now adopted (15a), holds that a defalcation can be established only upon a "showing of extreme recklessness"—a showing of "scienter" as required "in the context of securities fraud." *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002) (holding,

[11] The Seventh Circuit did not have to resolve the issue in *Meyer v. Rigdon*, because the default judgment against the debtor/bank president in a prior federal court action, on which the Seventh Circuit based its finding of "defalcation," had been based on allegations that he had "knowingly breached" his fiduciary duty to the bank.

nevertheless, that a debt arising from the use of trust funds for personal expenses was non-dischargeable because "[d]efalcation may be presumed from [a fiduciary's] breach of the duty of loyalty"). As articulated by these Circuits, a defalcation by a corporate fiduciary can be established only by "a showing of conscious misbehavior or extreme recklessness (15a)," requirements which do not appear in the statute or its legislative history.[12]

Neither the First nor Second Circuit has offered any statutory justification for taking this view, other than the assertion that, because the term "defalcation" appears in the same section as the words "fraud," "larceny" and "embezzlement," it should be construed as requiring the same, or nearly the same level of wrongful intention.[13]

The Second Circuit's adoption of a "scienter" requirement in this case is irreconcilable with *Hammond*. Indeed, in *Hammond*, the Second Circuit had held that a prior adjudication that a corporate director had breached his duty of loyalty to a corporation, was sufficient to establish a "misappropriation"under Section 17(a)(4) of the

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[12] "The Tenth Circuit's standard is not entirely clear . . . *** [and] [t]he Eleventh Circuit also has yet to adopt a clear standard" (14a).

[13] The dictionary certainly does not support this view. As the Second Circuit acknowledged:

> Defalcation is defined in Black's Law Dictionary (8th ed. 2004), as "loosely, the failure to meet an obligation" and "*a non-fraudulent* debt." *Id.* at 427; see Oxford English Dictionary 389 (2d ed. 1989) ("a monetary deficiency *through breach of trust* by one who has the management or charge of funds") (11a) (emphasis added).

Bankruptcy Act (now Bankruptcy Code § 523(a)(4)); no showing of any "conscious purpose . . . to defraud" or other "conscious wrongdoing" was necessary to render the debt nondischargeable. 98 F.2d at 704, 705.[14] Claims that the self-dealing fiduciary acted in "good faith" and "had no intention of despoiling his cestui," have been and should be rejected. *See Hammond*, 98 F.2d at 705; *Johnson*, 691 F.2d at 254, 257.

Ironically, it was Justice Learned Hand's analysis of the predecessor to Bankruptcy Code § 523(a)(4) in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937), that laid the groundwork for the view that even innocent defaults could constitute a defalcation under this section.

> Colloquially perhaps the word "defalcation," ordinarily implies some moral dereliction, but in this context [the first reference to defalcation in the Bankruptcy Code] it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts. . . . Whatever was the original meaning of "defalcation," it must here [in the Bankruptcy Act of 1867] have covered other defaults than deliberate

[14] As previously noted, the debtor in *Hammond* was found liable for profits made on the sale of stock which he purchased to enable the corporation to obtain access to valuable patents, notwithstanding the acknowledged benefit to the corporation. It was undisputed that he made the purchase, along with his co-directors, with their own funds, because the corporation was unable to do so, and that the corporation benefitted from the purchase.

> malversations, else it added nothing to the words, "fraud or embezzlement." . . . .
>
> * * *
>
> We must give the words different meanings so far as we can, especially when a contrary interpretation would wrest "defalcation," if not from its original meaning, at least from that which it must have had in the Act of 1867.

93 F.2d at 511-12. Significantly, in *Herbst*, the Second Circuit held that a receiver had committed a defalcation solely because he had spent and was unable to repay a previously awarded supplemental fee, after the award was reversed on appeal—hardly the kind of intentional misconduct or "extreme recklessness" the Second Circuit has decreed in this case.

Plainly, the dischargeability of a judgment against a corporate fiduciary based on self-dealing should not depend on the jurisdiction in which it was rendered. Nor should it depend on the vagaries of the various Bankruptcy Courts' views on whether such a finding imports "intentional," "reckless" or "innocent" behavior. We can conceive of no case where a corporate fiduciary would be found to have engaged in self-dealing for personal gain, without having acted intentionally, whether or not he is specifically found to have intended to do so. His intentions (as in the case at bar) are inherent in the conduct for which he has been held liable. The "misappropriation" and "exploitation" of corporate assets for personal gain is never unintentional.

From time immemorial protestations of "good faith" or "good intentions" have been rejected as a defense to fiduciary self-dealing; the law governing discharge in bankruptcy should be no different.

II. Review Should Also Be Granted Because the Second Circuit's Decision Necessarily Undermines Common Law Remedies Against Self-Dealing Corporate Officers and Directors.

In the case at bar, the Surrogate's findings could not have been clearer:

> (a) "[a]s a 50% shareholder, officer and director of Denton-Hyman, NPS and NPA, Hyman [Debtor] owed a fiduciary duty to those corporations" which he violated by "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency [his 100% owned corporation] and for his own personal enrichment" (92a);
>
> (b) "that Hyman [Debtor] exploited the assets of NPS and NPA to obtain profits for himself" (90a); and
>
> (c) that "his actions constituted a misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA" (92a-93a).[15]

He likewise rejected Debtor's "good faith" and ratification defenses (88a, 98a), which were "dismissed . . . in their entirety." (*Id.*).

[15] If these findings do not constitute "defalcation" for Bankruptcy Code purposes, what would?

The common law of New York holds corporate officers and directors to a higher standard " . . . than the morals of the marketplace." *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1926). As the Appellate Division, First Department, explained in *Foley v. D'Agostino*, 21 A.D2d 60, 66-67, 248 N.Y.S.2d 121, 128 (1st Dep't 1964):

> 'Directors and officers shall discharge the duties of their respective positions in good faith ***'. They may not assume and engage in the promotion of personal interests which are incompatible with the superior interests of their corporation. 'Officers and directors of a corporation owe to it their undivided and unqualified loyalty. *** They should never be permitted to profit personally at the expense of the corporation. Nor must they allow their private interests to conflict with the corporate interests. These are elementary rules of equity and business morality. Courts of equity must ever enforce strict compliance with these rules.' [citations omitted] In fact, 'When it appears that the trustee or officer has violated the moral obligation to refrain from placing himself in relations which ordinarily produce a conflict between self-interest and integrity, there is in equity a presumption against the transaction, which he is required to explain.' (*Sage v. Culver*, 147 N.Y. 241, 247, 41 N.E. 513, 514.) So it follows that an officer or director who actively engages in a rival or competing business to the detriment of his corporation, must answer to the corporation for the injury it thereby sustains.

Accord Matter of Greenberg, 206 A.D.2d 963, 964, 614 N.Y.S.2d 825, 827 (4th Dep't 1994) (officer's or director's "dealings with respect to corporate assets are subject to close scrutiny and must be characterized by absolute good faith; he may not appropriate corporate assets or opportunities to himself or to a new corporation formed for that purpose").

In state court litigation against such corporate fiduciaries, specific findings that such persons intended to self-deal are unlikely to be made because, under the applicable common law they are neither pleaded, proven nor necessary to the court's determination; they are inherent in the very nature of the fiduciary's acts. One does not "unintentionally" self-deal.

It is axiomatic that the Full Faith and Credit Clause of the Constitution (Article IV, § 1), as implemented by 28 U.S.C. § 1738, "requires federal courts to give the same preclusive effect to State court judgments that those judgments would be given in the courts of the state from which the judgments emerged." *Kremer v. Chemical Construction Corp.*, 456 U.S. 461, 466, 102 S. Ct. 1883 (1982). *Accord Parson Steel, Inc. v. First Alabama Bank*, 474 U.S. 518, 523, 106 S. Ct. 768 (1986). This "statute has long been understood to encompass the doctrines of res judicata, or "claim preclusion," and collateral estoppel, or "issue preclusion." *San Remo Hotel, L.P. v. City and County of San Francisco*, 545 U.S. 323, 336, 125 S. Ct. 2491 (2005), *citing Allen v. McCurry*, 449 U.S. 90, 94-96 101 S. Ct. 411 (1980). This Court has specifically recognized the applicability of collateral estoppel in claims for non-discharge-

ability under Bankruptcy Code § 523(a). *Grogan v. Garner*, 498 U.S. 279, 284 n. 11, 111 S. Ct. 654 (1991).

Those Circuits who insist on findings of "conscious misbehavior" or "extreme recklessness" amounting to the same have laid a trap for the unwary state court judgment creditor. Despite findings against a corporate fiduciary for self-dealing, such creditors will find their judgments effectively nullified, if such specific, and unnecessary, findings are not made by the state courts. In New York, at least, corporate fiduciary judgment debtors now need only repair to the Bankruptcy Court to obtain complete exoneration.

Moreover, under the Second Circuit's rationale, even if a state court makes the findings it now requires, any resulting judgment will be insufficient to support a claim of nondischargeability under § 523(a)(4). The Second Circuit premised its decision on the theory that because under New York law "good faith or innocent motives" are not a defense to a claim of breach of fiduciary duty, the state court was not required to, and thus did not necessarily, find that Debtor acted with culpable intent (16a-18a). Thus, even if the state court made the "appropriate findings of conscious misbehavior or recklessness" (16a), such findings, being "unnecessary" for the court's decision under state law, could not serve as a basis for collateral estoppel, which only accords preclusive effect to "necessary" findings. The "defalcation" exception to dischargeability, in the context of corporate fiduciary self-dealing, is now

rendered nugatory, Bankruptcy Code § 523(a)(4) to the contrary notwithstanding.

This gross inequity can be avoided if this Court rules, as in *Johnson* and *Hammond*, that any claimed ignorance of the law or alleged "good faith" by a corporate fiduciary is not a defense to nondischargeability, consistent with the common law, and the plain wording of the Bankruptcy Code. It is enough, as noted in the passage cited by the Second Circuit from New York Jurisprudence, that "the directors know that the use they are making of the assets is not for the benefit of the company, but for the use and benefit of other enterprises in which they are interested" (17a, quoting 14A N.Y. Jur.2d, Business Relationships § 695 (2006)).

CONCLUSION

For all of the foregoing reasons, a writ of certiorari should be granted.

Dated: New York, New York
January 17, 2008

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 2006

(Argued: September 18, 2006
Decided: September 6, 2007)

Docket No. 05-7026-bk

IN RE: ANDREW A. HYMAN,

Debtor.

G. HALLETT DENTON, As Executor of the Estate of George W. Denton,

Appellant,

—v.—

ANDREW A. HYMAN,

Debtor-Appellee.

Before:

CALABRESI and B. D. PARKER, *Circuit Judges,* and LYNCH*, *District Judge.*

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* The Honorable Gerard E. Lynch, United States District Court for the Southern District of New York, sitting by designation.

Appeal from a judgment of the United States District Court for the Southern District of New York (Conner, *J.*) affirming the Bankruptcy Court's (Hardin, *J.*) ruling that collateral estoppel based on findings in prior Surrogate's Court proceedings did not preclude relitigation of a non-dischargeability claim. *See* 11 U.S.C. § 523(a).

AFFIRMED.

KENNETH L. STEIN (Norman A. Senior & Jeffery H. Sheetz, *of counsel*), Greenfield Stein & Senior, LLP, New York, NY, *for Appellant G. Hallett Denton*.

ANTHONY L. TERSIGNI, Meyers Tersigni Feldman & Gray, LLP, New York, NY (Richard N. Gray, Meyers Tersigni Feldman & Gray, New York, NY; M. Stuart Goldberg, White Plains, NY, *on the brief*), *for Appellee Andrew A. Hyman*.

BARRINGTON D. PARKER, *Circuit Judge*:

Appellant G. Hallett Denton ("Denton"), the executor of the estate of George W. Denton, appeals from a judgment of the United States District Court for the Southern District of New York (Conner, *J.*). The district court affirmed an order of the Bankruptcy Court (Hardin, *J.*) that collateral estoppel did not relieve Denton from proving that a debt owed the estate by Appellee

Andrew Hyman ("Hyman") was not dischargeable under § 523(a)(4) of the Bankruptcy Code. That section of the Code precludes discharge of a debt resulting from a debtor's "defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). During prior litigation, the Westchester County, New York Surrogate's Court ruled that Hyman, in dealings with the Denton estate, breached his fiduciary duties and misappropriated assets. Both the Bankruptcy Court and the District Court ruled that collateral estoppel did not attach to this finding because the issue of whether Hyman committed a "defalcation" within the meaning of the Bankruptcy Code had not actually been decided by the Surrogate. We agree and we affirm, although on somewhat different grounds.

I. BACKGROUND

In 1984 Hyman and George W. Denton ("G.W. Denton") began working for an insurance agency in Westchester County, New York owned by Henry Deppe. The agency represented the Guardian Life Insurance Company of America and, among other activities, marketed Guardian life insurance products through pension plans. These plans were designed and administered through a separate company, National Pension Services, Inc., also owned by Deppe, which channeled business to his insurance agency.

In 1987, G.W. Denton and Hyman took over the business from Deppe and formed their own insurance agency, the Denton-Hyman Agency ("Denton-Hyman"), as well as their own pension administration company, also called National

Pension Service, Inc. ("NPS"), and a third company, National Pension Actuaries ("NPA"), which generated business for the agency but was not profitable. Each owned fifty percent, and served as director and executive officer, of the three companies. Guardian designated G.W. Denton and Hyman to succeed Deppe as Guardian's agent for Westchester County under an agreement which provided that, if either left the business, their agency relationship with Guardian would terminate. In starting these businesses, G.W. Denton and Hyman incurred substantial debts—exceeding $1.6 million—which they guaranteed jointly and severally. As was the case with Deppe's agency, NPS generated business for Denton-Hyman, but operated at a loss.

In 1989, thirteen months after starting these businesses, G.W. Denton died unexpectedly and Hyman succeeded him as president and sole director of the three corporations. At that point, the agency relationship between Guardian and Denton-Hyman automatically terminated and, in accordance with Guardian's regulations, both the Denton estate and Denton-Hyman were ineligible to become shareholders in the new general agency. Denton-Hyman, however, still owed $1.6 million in start-up debt for which Denton's estate and Hyman were personally liable. To service this obligation Hyman looked, among other sources, to commission income earned by the Denton-Hyman agency during the thirteen-month period prior to G.W. Denton's death but received afterwards. After G.W. Denton's death, Guardian accepted Hyman as its agent and, to service the Guardian business, he formed the

Andrew A. Hyman Agency ("Hyman Agency"). Hyman continued to operate NPS, and to fund its deficits so that it would continue to generate business for the Hyman Agency. By 1994, when Hyman's relationship with Guardian terminated, Hyman had liquidated the $1.6 million debt with the estate's consent, using jointly owned assets —the residual commissions earned by Denton-Hyman—and the earnings of the Hyman Agency.

In addition to running the agency and paying down the debt, Hyman also engaged in lengthy negotiations with G. Hallett Denton, the executor of G.W. Denton's estate, for the purchase of the estate's fifty percent interest in Denton-Hyman, NPS and NPA. These negotiations were protracted and difficult, and seem to have foundered over the issue of how much of the income Hyman generated belonged to him and how much needed to be shared with the estate. At the end of the day, no agreement was reached.

At this point, Denton sued Hyman in Surrogate's Court. Denton asserted a derivative claim on behalf of Denton-Hyman, seeking to recover "profits earned by Hyman and the Hyman Agency in exploiting assets of [the jointly-owned] corporations" and "damages suffered as a result of the diversion of corporate assets." Hyman asserted a number of affirmative defenses including ratification and estoppel. After a nine-day trial, the Surrogate's Court entered judgment in favor of the estate and against Hyman and the Hyman Agency for $2,734,832, "representing the net profits obtained by [them] as a result of Hyman's breach of fiduciary duty, as an officer, director and 50% shareholder of Denton-Hyman, NPS,

and NPA and their misappropriation of the assets and goodwill of said Corporations." In so ruling, the Surrogate's Court found that Hyman had breached his fiduciary duty by "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment," using furniture and fixtures of the corporations without compensation, and using "Denton-Hyman overrides to subsidize NPS and NPA and to satisfy the Hyman Agency debt to the Guardian."

Although the Surrogate's conclusions were undoubtedly damaging to Hyman, they were not accompanied by in-depth analysis of a number of issues relevant to this appeal. The Surrogate, for example, made no findings concerning Hyman's state of mind: In using jointly owned assets and income generated by his own efforts both to liquidate debt of the estate and to operate the business that was generating the income, was Hyman breaching a fiduciary obligation by being sloppy or venal or was he stealing? In addition, the Surrogate's decision gave little prominence to the substantial monetary benefits Hyman conferred on the estate. Nor did it specifically address Hyman's argument that the estate's representatives acquiesced in, and consented to, Hyman's conduct over a lengthy period.

In February 2003, Hyman filed for protection under the bankruptcy laws. Denton, as executor of G.W. Denton's estate, then filed a claim based on the Surrogate's Court's judgment, to declare that judgment non-dischargeable under § 523(a)(4) of the Bankruptcy Code as a debt arising from "defalcation while acting in a fidu-

ciary capacity." Denton contended that the Surrogate's findings were conclusive and that Hyman was collaterally estopped from contesting them.

The Bankruptcy Court found the Surrogate's Court's judgment valid and enforceable and allowed Denton's claim based on the judgment. However, the court rejected Denton's contention that collateral estoppel precluded further litigation over the dischargeability of the debt. The Bankruptcy Court ruled that under § 523(a)(4) "defalcation" was narrower than the concept of "misappropriation" under state law, with defalcation requiring "some portion of misconduct." The court then concluded that the Surrogate's Court's findings failed to satisfy the more restrictive definition. In reaching this conclusion, the court emphasized Denton's failure to identify any specific conduct of Hyman's that amounted to a defalcation or that could be characterized as wrongful, illegal or morally reprehensible, "other than the fact that the parties did not reach agreement on a buy out."

Because Denton had voluntarily dismissed alternative claims for relief, and had agreed to abide by the Bankruptcy Court's resolution of the collateral estoppel issue rather than retry the claim, the Bankruptcy Court issued a final judgment in favor of Hyman, and Denton appealed to the district court. The district court affirmed. Judge Conner ruled that defalcation requires some element of wrongful intent, so as to be more than a "mere negligent" or innocent act, and held that because the Surrogate's Court made no finding as to Hyman's intent, it necessarily failed to decide the issue of defalcation. The district

court found that Hyman's immediate offer to buy out the estate's interest, the three-year-long negotiation over the purchase price, and the pay down of the $1.6 million in debt did not demonstrate the level of misconduct necessary to trigger the application of § 523(a)(4). Specifically, Judge Conner concluded that "Debtor's conduct throughout was fully consistent with a good faith effort to preserve the business for the mutual benefit of AHA and the Estate." This appeal followed.

II. DISCUSSION

A. Standard of Review

Our review of a district court's order in its capacity as an appellate bankruptcy court is plenary. *In re DeTrano*, 326 F.3d 319, 321 (2d Cir. 2003). The factual determinations and legal conclusions of the Bankruptcy Court are, therefore, reviewed independently by this Court. *Id.* The Bankruptcy Court's legal conclusions are reviewed *de novo* and its factual conclusions are reviewed for clear error. *Id.*

B. New York's Law of Collateral Estoppel

To determine whether collateral estoppel applies to the Surrogate's Court's judgment, we look to New York law. *See Marrese v. Am. Acad. of Orthopaedic Surgeons*, 470 U.S. 373, 380 (1985); *Colon v. Coughlin*, 58 F.3d 865, 869 n.2 (2d Cir. 1995). Under New York law, collateral estoppel bars relitigation of an issue when (1) the identi-

cal issue necessarily was decided in the prior action and is decisive of the present action, and (2) the party to be precluded from relitigating the issue had a full and fair opportunity to litigate the issue in the prior action. *Kaufman v. Eli Lilly & Co.*, 65 N.Y.2d 449, 455-56 (1985); *see Jeffreys v. Griffin*, 1 N.Y.3d 34, 39 (2003); *Buechel v. Bain*, 97 N.Y.2d 295, 303-04 (2001); *see also Khandahar v. Elfenbein*, 943 F.2d 244, 247 (2d Cir. 1991). Under New York law, collateral estoppel is a flexible doctrine and whether to apply it a particular case depends on "general notions of fairness involving a practical inquiry into the realities of the litigation." *Jeffreys*, 1 N.Y.3d at 41.

On this appeal, these principles must be analyzed jointly with others that have special significance in the bankruptcy context. The basic policy animating the Bankruptcy Code is to afford the "honest but unfortunate" debtor a fresh start. *Marrama v. Citizens Bank of Mass.*, 127 S. Ct. 1105, 1107 (2007); *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991); *DeTrano*, 326 F.3d at 322. The consequences to a debtor whose obligations are not discharged are considerable; in many instances, failure to achieve discharge can amount to a financial death sentence. In view of these harsh consequences, exceptions to discharge are to be narrowly construed and genuine doubts should be resolved in favor of the debtor. *In re Renshaw*, 222 F.3d 82, 86 (2d Cir. 2000); *In re Hayes*, 183 F.3d 162, 167 (2d Cir. 1999).

The first critical question is whether a "defalcation while acting in a fiduciary capacity" under § 523(a)(4) of the Bankruptcy Code is identical to

the factual and legal determinations necessarily decided in the prior Surrogate's Court action. Denton argues that the issue of whether a defalcation occurred was necessarily decided by the Surrogate's Court's findings that Hyman breached his fiduciary duty and misappropriated assets. Hyman contends that in view of the pervasive confusion in the federal courts over what constitutes "defalcation" under § 523(a)(4), and also in view of the harsh consequences that attach and the requirement that doubts in a close case such as this should be resolved in his favor, he should not be denied the opportunity to prove at a trial in Bankruptcy Court that he did not violate § 523(a)(4).

C. Whether "Defalcation" Was Necessarily Decided

While the Code generally allows for the discharge of debts, significant exceptions exist. *DeTrano*, 326 F.3d at 322. Among them is § 523(a)(4) excepting from discharge any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. § 523(a)(4). As previously noted, this exception, like most, must be narrowly construed. *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998) (observing that exceptions to discharge "'should be confined to those plainly expressed'") (quoting *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)); *Renshaw*, 222 F.3d at 86.

There has been much debate among the Circuits over whether a "defalcation" under § 523(a)(4) includes all misappropriations or failures to account or only those that evince some

wrongful conduct.[1] *See Zohlman v. Zoldan*, 226 B.R. 767, 775 (S.D.N.Y. 1998) (discussing the circuit split). This Circuit, although previously having suggested that "some portion of misconduct" may be required to establish a "defalcation" under § 523(a)(4), has yet to squarely address this issue. *Cent. Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937); *see Hayes*, 183 F.3d at 172 (assuming that defalcation demands "some portion of misconduct," in finding that the debtor committed a defalcation).

In *Herbst*, 93 F.2d at 511-12, Judge Learned Hand wrestled with this problem without resolving it. He wrote:

> Colloquially perhaps the word, "defalcation," ordinarily implies some moral dereliction, but in this context [the first reference to defalcation in the Bankruptcy Code] it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts. It must be remembered that the "fiduciary capacity" was limited to "special" or "technical" fiduciaries.
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> . . . .
>
> Whatever was the original meaning of "defalcation," it must here [in the Bankruptcy Act of 1867] have covered other

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[1] Defalcation is defined in Black's Law Dictionary (8th ed. 2004), as "loosely, the failure to meet an obligation" and "a non-fraudulent debt." *Id.* at 427; *see* Oxford English Dictionary 389 (2d ed. 1989) ("a monetary deficiency through breach of trust by one who has the management or charge of funds").

> defaults than deliberate malversations, else it added nothing to the words, "fraud or embezzlement."[2]
>
> . . . .
>
> We must give the words different meanings so far as we can, especially when a contrary interpretation would wrest "defalcation," if not from its original meaning, at least from that which it must have had in the Act of 1867.
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> . . . .
>
> We do not hold that no possible deficiency in a fiduciary's accounts is dischargeable; in [*In*] *Re Bernard,* 87 F.2d 705, 707 [(2d Cir. 1937)], we said that "the misappropriation must be due to a known breach of the duty, and not to mere negligence or mistake." Although that word probably carries a larger implication of misconduct than "defalcation," "defalcation" may demand some portion of misconduct; we will assume arguendo that it does.

Denton relies on *In re Hammond*, 98 F.2d 703, 704 (2d Cir. 1938), for the proposition that no actual intent is necessary to establish a defalcation. *Hammond* involved our determination of whether the unlawful appropriation of a corporate contract constituted a "misappropriation" under the previous version of § 523(a)(4), absent

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[2] The Act found non-dischargeable debts resulting from "defalcation as a public officer, or while acting in any fiduciary character," fraud or embezzlement. *Herbst*, 93 F.2d at 511.

any finding by the lower court of a "conscious wrongdoing" or "purpose to defraud." *Id.* at 704, 705. *Hammond* does not stand for the proposition that a "misappropriation" under this provision can be found absent a wrongful intent. In *Hammond*, we held that a wrongful or evil intent, if required by the provision, *could* be inferred based on the debtor's intentional unlawful act and by finding the debtor chargeable with the knowledge that his actions violated the law. *Id.* at 705.

The Fourth, Eighth, and Ninth Circuits hold that an innocent mistake can constitute a defalcation. *In re Uwimana,* 274 F.3d 806, 811 (4th Cir. 2001) ("[N]egligence or even an innocent mistake which results in misappropriation or failure to account is sufficient."); *In re Hemmeter,* 242 F.3d 1186, 1190 (9th Cir. 2001) ("Even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations."); *In re Cochrane,* 124 F.3d 978, 984 (8th Cir. 1997) ("Defalcation includes the innocent default of a fiduciary who fails to account fully for money received.").[3]

The majority of the Circuits addressing this issue, however, require some level of wrongful conduct in order to find a defalcation under § 523(a)(4). The Fifth, Sixth, and Seventh Circuits require a level of fault greater than mere negligence. *In re Schwager*, 121 F.3d 177, 185 (5th Cir. 1997) ("While defalcation may not

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[3] The Ninth Circuit does, however, more strictly limit the application of defalcation to fiduciary of trusts and relationships that exhibit characteristics of the traditional trust relationship. *Hemmeter*, 242 F.3d at 1189-90.

require actual intent, it does require some level of mental culpability. It is clear in the Fifth Circuit that a 'willful neglect' of fiduciary duty constitutes a defalcation—essentially a recklessness standard."); *Meyer v. Rigdon,* 36 F.3d 1375, 1384-85 (7th Cir. 1994) ("[A] mere negligent breach of a fiduciary duty is *not* a 'defalcation' under section 523(a)(11)."); *In re Johnson,* 691 F.2d 249, 257 (6th Cir. 1982) (ruling that while "subjective intent to violate a known fiduciary duty or bad faith is irrelevant," the misuse of monies as the result of negligence or a mistake of fact does not constitute defalcation). The Tenth Circuit's standard is not entirely clear but at least requires "some portion of misconduct." *Compare In re Storie*, 216 B.R. 283, 288 (B.A.P. 10th Cir. 1997) (announcing a standard requiring that includes "intentional, wilful, reckless or negligent" breaches of fiduciary duty), *with In re Millikan,* 188 Fed. App'x 699, 702 (10th Cir. 2006) (unpublished) (declining to identify a specific standard but requiring "some portion of misconduct" to prove defalcation). The First Circuit set the highest bar, requiring a showing of extreme recklessness, "akin to the level of recklessness required for scienter [in securities law]." *In re Baylis,* 313 F.3d 9, 20 (1st Cir. 2002). In so ruling, the First Circuit interpreted "defalcation" as requiring a degree of fault, "closer to fraud, without the necessity of meeting a strict specific intent requirement."[4] *Id.* at 18-19.

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[4] The Eleventh Circuit also has yet to adopt a clear standard. *See In re Fernandez-Rocha,* 451 F.3d 813, 817 (11th Cir. 2006) (discussing the different possible interpretations of defalcation); *Quaif v. Johnson,* 4 F.3d 950,

In light of this persistent confusion, we now align ourselves with the First Circuit, *see Baylis*, 313 F.3d at 20, in holding that defalcation under § 523(a)(4) requires a showing of conscious misbehavior or extreme recklessness—a showing akin to the showing required for scienter in the securities law context. *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 168 (2d Cir. 2000); *Novak v. Kasaks*, 216 F.3d 300, 308 (2d Cir. 2000); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999). We believe that these concepts—well understood and commonly applied in the securities law context—strike the proper balance under § 523(a)(4). This standard ensures that the term "defalcation" complements but does not dilute the other terms of the provision—"fraud," "embezzlement," and "larceny"—all of which require a showing of actual wrongful intent. *See In re Stern*, 231 B.R. 25, 26 (S.D.N.Y. 1999) (noting that larceny under § 523(a)(4) requires a showing of fraudulent intent to convert another's property to debtor's own use); *In re Caulfield*, 192 B.R. 808, 818 (Bankr. E.D.N.Y. 1996) (requiring a showing of fraudulent intent for larceny and embezzlement); *see also In re Zois*, 269 B.R. 89, 101 (Bankr. S.D.N.Y. 1999) (requiring a showing of intentional deceit to establish "fraud" under this section); 4 Collier on Bankruptcy § 523.10(1)(a) (15th ed. rev. 2007) ("'Fraud' for purposes of this exception has generally been interpreted as involving intentional deceit, rather than implied or constructive fraud.").

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955 (11th Cir. 1993) (finding a defalcation where the improper transfer of funds by a fiduciary "was far more than an innocent mistake or even negligence").

By requiring the courts to make appropriate findings of conscious misbehavior or recklessness in the course of dischargeability litigation, the standard we adopt today insures that the harsh sanction of non-dischargeability is reserved for those who exhibit "some portion of misconduct." *Herbst*, 93 F.2d at 512. The standard does not reach fiduciaries who may have failed to account for funds or property for which they were responsible only as a consequence of negligence, inadvertence or similar conduct not shown to be sufficiently culpable. This standard, we believe, also has the virtue of ease of application since the courts and litigants have reference to a robust body of securities law examining what these terms mean.

In finding that Hyman breached his fiduciary duty by "misappropriating and co-opting assets of the jointly-owned companies for his personal benefit," the Surrogate's Court made no express findings with regard to Hyman's state of mind. We assume that the Surrogate concluded that under New York law such findings were not necessary, since misappropriation and breach of fiduciary duties apparently do not, under New York law, consistently require proof of a culpable mental state. *See Strough v. Bd. of Supervisors*, 3 N.Y.S. 110, 112 (N.Y. Gen. Term 1888), *modified on other grounds and aff'd*, 119 N.Y. 212 (1890) (holding defendant liable for "illegal, though innocent in intent, misappropriation"); *Matter of Happy Time Fashions*, 7 B.R. 665, 670 (Bankr. S.D.N.Y. 1980) (noting that good faith or

innocent motives are no defense to a corporate officer's breach of fiduciary duties).[5]

Having clarified the standard under § 523(a)(4) and given the unique circumstances of this case, we decline to mechanically apply collateral estoppel. *See Jeffreys*, 1 N.Y. 3d at 41; *People v. Roselle*, 84 N.Y.2d 350, 357 (1994) ("[C]ollateral estoppel, a flexible doctrine, should not be mechanically applied just because some of its formal prerequisites, like identity of the parties, identity of issues, a final and valid prior judgment and a full and fair opportunity to litigate the prior determination, may be present."); *Halyalkar v. Bd. of Regents*, 72 N.Y.2d 261, 269 (1988) (declining to give an administrative consent order preclusive effect and noting that the doctrine of collateral estoppel "should never be rigidly or mechanically applied"). The Surrogate had neither the ability nor the incentive to apply the standard we announce. Moreover, the record contains evidence of Hyman's good faith in using the proceeds of the new Agency to pay off the debts for which both he and the Denton estate

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[5] The New York Jurisprudence states:

> Corporate directors and officers will be held accountable for the wrongful use, diversion, or misappropriation of corporate funds or property in an action appropriate for the enforcement of such liability. Good intentions do not justify the misapplication or misuse of corporate assets where the directors know that the use they are making of the assets is not for the benefit of the company, but for the use and benefit of other enterprises in which they are interested.

N.Y. Jur. 2d, 14A Business Relationships § 695 (2006).

were liable, and in attempting for years to negotiate a buy-out with the Denton estate[6]—all of which could militate against the required showing of recklessness or conscious misbehavior. As noted above, the Surrogate's Court was not required to take such considerations into account when reaching its conclusions concerning misappropriation and breach of fiduciary duty. In view of these complexities, we are loath to conclude that an identical issue was necessarily decided or that Hyman had a full and fair opportunity to contest his state of mind. In addition to the murkiness of the law, the harsh consequences that follow a finding of nondischargeability and the requirement that exceptions be narrowly construed both counsel against precluding a plenary trial in Bankruptcy Court, had the estate not voluntarily agreed to forego one here. Accordingly, we conclude that collateral estoppel does not attach.

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[6] Denton argues that the Surrogate's Court effectively did find an absence of good faith in rejecting Hyman's affirmative defenses of ratification and consent. Even if the Surrogate did clearly reject Hyman's argument that Denton consented to these acts—which is entirely unclear—a lack of good faith was not necessarily decided by the Surrogate's rejection of Hyman's affirmative defenses. Even absent Denton's consent or ratification of Hyman's acts, good faith could still be found based on evidence in the record. As indicated by the Bankruptcy Court and the district court, there is other evidence, namely the extensive buy-out negotiations and the payment of Denton-Hyman debt that stands as evidence of good faith on Hyman's part; therefore a lack of ratification and consent would not necessarily decide the existence of good faith.

III. CONCLUSION

The district court's judgment is AFFIRMED.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Chapter 7
Bankruptcy Court Case No.
03 B 22150 (ASH)

IN RE:

ANDREW A. HYMAN,

Debtor.

G. HALLETT DENTON, as Executor of
the Estate of George W. Denton,

Plaintiff-Appellant,

—against—

ANDREW A. HYMAN,

Defendant-Appellee.

ECF CASE

05 CIV. 2867 (WCC)

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OPINION AND ORDER

CONNER, Senior D.J.:

Plaintiff-Appellant G. Hallett Denton ("Creditor"), executor of the estate of his deceased father, George W. Denton (the "Estate"), appeals the January 21, 2005 order of United States Bankruptcy Judge Adlai S. Hardin, Jr. denying Creditor's motion for summary judgment and granting the cross-motion of defendant-appellee Andrew Hyman ("Debtor") discharging Hyman's debt and dismissing Creditor's claims under Section 523(a) of the Bankruptcy Code based on collateral estoppel from the findings of the Westchester County Surrogate's Court. The issues presented on appeal under 11 U.S.C. § 523 are: (1) whether a judgment obtained in state court by a creditor against a debtor collaterally estops the debtor from relitigating certain issues in Bankruptcy Court; (2) what conduct constitutes defalcation for purposes of the Bankruptcy Code; and (3) whether equal shareholders in a close corporation are fiduciaries as that term is understood under the Bankruptcy Code. We affirm the decision of the Bankruptcy Court.

BACKGROUND

In 1984, George W. Denton and Hyman began working for an insurance agency owned by Henry A. Deppe (Hyman Aff. ¶ 3.) Deppe's insurance agency operated as a general agent of The Guardian Life Insurance Company of America ("Guardian") and marketed Guardian life insur-

ance through a separate entity called National Pension Service, Inc. ("NPS"), which designed and administered pension plans funded by life insurance sales. (*Id.* ¶¶ 3-4.) By 1987, Deppe was nearing retirement and agreed to recommend that Guardian permit Denton and Hyman to replace him as general agent.[1] (*Id.* ¶ 5.) Guardian subsequently named Denton and Hyman as successors to Deppe's general agency. (*Id.* ¶ 6.)

The pair organized Denton-Hyman Agency, Inc. ("DHA") to act as general agent and became equal shareholders of the company, with Denton serving as President and Hyman as Vice President. (*Id.*; Stein Decl., Ex. A at 1-2.) They also formed and took equal shares in both NPS and National Pension Actuaries, Inc. ("NPA") in order to continue Deppe's pension planning and administrative companies of the same names.[2] (Hyman Aff. ¶ 6 & n.1; Stein Decl., Ex. A at 1-2.) Accordingly, on or about January 1, 1988, Deppe executed agreements transferring the assets of each of his companies to their respective newly-formed counterparts, as well as an agreement not to compete, for a total price of $655,234, payable in installments and personally guaranteed by Denton and Hyman jointly and severally. (Hyman Aff. ¶ 6.) In addition, DHA and NPS incurred

[1] Guardian insurance agencies cannot be sold; the appointment of a general agency resides solely in Guardian's discretion. (Hyman Aff. ¶ 5.)

[2] By marketing life insurance through pension planning, Deppe's agency garnered substantial tax benefits under the then-existing tax laws and increased its life insurance sales beyond that capable through mere direct sales. (Hyman Aft ¶ 4; Pl.-Appellant Br. at 10.)

start-up financing debts of $1.6 million, also personally guaranteed by both Denton and Hyman jointly and severally. (*Id.* ¶¶ 9-10.)

On February 14, 1989, Denton died unexpectedly, just over one year after he and Hyman assumed control of the enterprise. (Stein Decl., Ex. A at 2.) No shareholder or similar agreement existed governing buyout or enterprise division in the event one of the men died or left the business. (11/15/04 Hr'g Tr. at 10.) The general agency granted by Guardian to DHA automatically terminated upon Denton's death. (Hyman Aff ¶ 11 & Ex. 2; 10/28/04 Hr'g Tr. at 24.) This "precluded the Denton estate or [DHA] from becoming a shareholder in the new general agency." (Stein Decl., Ex. A at 7.)

Immediately after Denton's death, Debtor began negotiating with Guardian to assume sole control of the DHA general agency, and, in October 1989, Guardian granted the general agency to Debtor as sole proprietor of the newly-formed Andrew A. Hyman Agency, Inc. ("AHA"). (*Id.*, Ex. A at 2-3; Hyman Aff. ¶ 14.) Additionally, Hyman assumed control of NPS and maintained its operations, but with all life insurance proceeds on a going-forward basis being collected by AHA instead of DHA. (Hyman Aff. ¶ 16; Stein Decl., Ex. A at 2-3.) Hyman also began immediate discussions with Creditor regarding both the continuation of these businesses and the purchase of the Estate's half-interest in DHA. (Hyman Aff. ¶¶ 12-13, 16-17.) Both parties were aware that allowing the businesses to lapse would affect the amount of DHA/NPS debts for which the Estate would be responsible, as Hyman lacked sufficient

funds to satisfy those debts and all debts were incurred jointly and severally. (*Id.* ¶ 10; 10/28/04 Hr'g Tr. at 23.) It appears that Creditor consented to Debtor's continuation of the business and actively engaged in buyout negotiations. (Stein Reply Decl., Ex. 7 at 175-76, 210.) Hyman continued running AHA until 1994, when AHA was replaced as Guardian's general agent; NPS and NPA operated with Hyman as director until April 2002, at which time their operations were outsourced. (Stein Decl., Ex. A at 3.) By this time, Hyman had paid off the entire $1.6 million debt owed by DHA and NPS, apparently through the use of monies still owed DHA in addition to funds earned by AHA. (Hyman Aff. ¶ 30.)

From 1989 to 1994, Creditor and Debtor engaged in lengthy, arms length negotiations in which both parties were advised by competent professionals concerning Hyman's purchase of the Estate's half-interest in the defunct DHA. (*Id.* ¶¶ 19-25 & Ex. 10; Stein Reply Decl., Ex. 7 at 176-77, 181-82, 210.) When these negotiations failed to produce an agreement, Creditor filed a shareholder derivative claim against Debtor in Westchester County Surrogate's Court. (Hyman Aff. ¶ 20.) That court issued a post-trial decision dated December 21, 2002, and Decree dated April 23, 2003, requiring Hyman to pay roughly $2.7 million to DHA for profits collected by AHA after Denton's death. (Stein Decl., Exs. A & B.) The Appellate Division affirmed the Surrogate's Court's decision on April 12, 2004. (*Id.*, Ex. E ¶ 19.)

However, before the Surrogate's Court issued its Decree, Debtor filed for Chapter 11 protection in recognition of his inability to pay the antici-

pated judgment; the case was converted to Chapter 7. (Stein Decl., Ex. E ¶ 10.) Consequently, Creditor filed a claim in Debtor's bankruptcy case seeking an order fixing and allowing the Estate's claim in the amount of the Surrogate's Court's judgment and an order excepting the debt from discharge under 11 U.S.C. §§ 523(a)(2), (4) and (6). Creditor and Debtor each filed motions and cross-motions for summary judgment, which resulted in an oral decision by Bankruptcy Judge Hardin rejecting a number of Creditor's claims but establishing a schedule leading to a trial on the merits of Creditor's claim under Section 523(a)(4). Before trial, Creditor voluntarily dismissed with prejudice the nondischargeability claim under 523(a) in order to forego a trial and immediately proceed with an appeal regarding the issue of collateral estoppel based upon the Surrogate's Court's decision. Judge Hardin accordingly issued an appealable, final decision and order on January 21, 2005, which this Court now addresses. This Court has jurisdiction over this appeal pursuant to 28 U.S.C. § 158.

DISCUSSION

I. *Standard of Review*

On appeal, a bankruptcy court's legal conclusions are reviewed *de nova*. *See In re Dawnwood Props./78*, 209 F.3d 114, 116 (2d Cir. 2000). However, the bankruptcy court's findings of fact cannot be set aside unless they are clearly erroneous. *See* FED. R. BANKR. 8013; *In re Dawnwood*, 209 F.3d at 116; *see also Gulf States*

Exploration Co. v. Manville Forest Prods. Corp. (In re Manville Forest Prods. Corp.), 896 F.2d 1384, 1388 (2d Cir. 1990).

On a claim of nondischargeability under § 523(a)(4), the Supreme Court has held that the burden is on the party claiming nondischargeability, and the appropriate level of proof is a preponderance of the evidence. *See Grogan v. Garner*, 498 U.S. 279, 285 (1991); *In re Hambley*, 329 B.R. 382, 396 (Bankr. E.D.N.Y. 2005). Exceptions to dischargeability should be literally and strictly construed against the creditor and liberally in favor of the debtor. *See, e.g., Gleason v. Thaw*, 236 U.S. 558, 562 (1915) ("In view of the well-known purposes of the bankrupt law, exceptions to the operation of a discharge thereunder should be confined to those plainly expressed . . . ."); *Household Fin. Corp. v. Danns (In re Danns)*, 558 F.2d 114, 116 (2d Cir. 1977); *Cmty. Mut. Say. Bank v. Landrin (In re Landrin)*, 173 B.R. 307, 310 (S.D.N.Y. 1994). This comports with the "fresh start" policy underlying the Bankruptcy Code. *See, e.g., Wetmore v. Markoe*, 196 U.S. 68. 77 (1904) ("Systems of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive, and to permit him to have a fresh start in business or commercial life, freed from the obligation and responsibilities which may have resulted from business misfortunes."); *Rupert v. Krautheimer (In re Krautheimer)*, 210 B.R. 37, 46 (Bankr. S.D.N.Y. 1997) ("The concept of the discharge is, without question, the 'holy grail' of the Bankruptcy Code."). "Thus, nondischargeability is 'perceived to be a punitive excep-

tion to the "fresh start" policy and should be found reluctantly.' " *In re Krautheimer*, 210 B.R. at 46 (quoting *Matter of Martonak*, 67 B.R. 727, 728 (Bankr. S.D.N.Y. 1986)).

II. *Collateral Estoppel*

Creditor's sole claim on appeal is that the Bankruptcy Court erred by not finding collateral estoppel based upon the finding of breach of fiduciary duty by the Westchester County Surrogate's Court.[3] Creditor claims that the state court's determination that Debtor "exploited" and "misappropriated" corporate assets constituted a finding of "defalcation while acting in a fiduciary capacity" within the terms of § 523(a)(4), thus estopping Debtor from relitigating those issues

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[3] Debtor recasts the issue as one of res judicata. Specifically, Debtor argues that Creditor's voluntary dismissal with prejudice of his fourth claim for relief—for nondischargeability on the merits—constitutes a final dismissal on the merits such that res judicata bars Creditor's first claim for relief—for nondischargeability due to collateral estoppel—because the claims are identical. According to Debtor, "Judge Hardin left for this Court's determination the legal effect of the voluntary dismissal of the fourth claim for relief on plaintiff's right to prosecute an appeal from the earlier dismissal of the first claim for relief." (Def.-Appellee Br. at 12.)

The Court finds no basis for this statement in either the Bankruptcy Court opinion or in statements made by Judge Hardin at the hearings in this case. The case law Debtor cites fails to establish the applicability of res judicata to claims adjudicated in the same action, as opposed to those adjudicated in previous actions. Moreover, the Bankruptcy Court found that Creditor in no way intended for the voluntary dismissal to have such an effect. (12/27/04 Hr'g Tr. at 7-8.)

and estopping the Bankruptcy Court from reassessing the factual predicate of those determinations.

It is well settled that collateral estoppel applies in bankruptcy proceedings, including those arising under Section 523(a). *See Grogan*, 498 U.S. at 284 n.11; *In re DeTrano*, 326 F.3d 319, 322 (2d Cir. 2003). However, in order for collateral estoppel to apply, the issue sought to be precluded must be identical to an issue actually and necessarily decided in the prior action. *See, e.g., Chartier v. Marlin Mgmt., LLC*, 202 F.3d 89, 94 (2d Cir. 2000). "The party asserting collateral estoppel bears the burden of demonstrating that it is entitled to this relief" *May Ship Repair Contracting Corp. v. Barge Columbia NY*, 160 F. Supp. 2d 594, 599 (S.D.N.Y. 2001) (citing *In re Sokol*, 113 F.3d 303, 306 (2d Cir. 1997)). Specifically, "[t]he party invoking collateral estoppel has the burden of identifying the precise issues litigated in the prior action and establishing a record sufficient to reveal the controlling facts." *In re Landrin*, 173 B.R. at 312 n.5.

Creditor fails to meet this burden. Creditor's reliance on the state court's characterization of Debtor's conduct as "co-option," "misappropriation" and "exploitation" of corporate assets does not persuade this Court that the issue of "defalcation," as that term is interpreted under the Bankruptcy Code, was previously decided. As this Court explained at length in *Zohlman v. Zoldan (In re Zoldan)*, 226 B.R. 767, 772 (S.D.N.Y. 1998) (Conner, J.), "the definition[ ] of . . . 'defalcation' for purposes of § 523(a)(4) [is a] highly specialized determination[ ], and [its]

meaning is narrowly confined to the bankruptcy context." Accordingly, the state court's limited opinion coupled with Creditor's inability to provide any indication of Debtor's wrongful conduct—despite the Bankruptcy Court's repeated requests to do so—renders it "impossible to say that the existence of. . . defalcation [was] 'specifically decided' by the state court." *Id.* (quoting *Nate B. & Francis Spingold Found., Inc. v. Halperin (In re Halperin),* 215 B.R. 321, 336 (Bankr. E.D.N.Y. 1997)). This result is required "since any reasonable doubt as to what was previously decided by a prior judgment should be resolved by deciding against using it as estoppel." *Id.*

III. *The Definition of "Defalcation"*

Section 523(a)(4) excepts from discharge a debt "for fraud or defalcation while acting in a fiduciary capacity." In *In re Zoldan,* this Court examined the meaning of "defalcation" at length after noting the widespread disagreement over its definition among those deciding the issue. 226 B.R. at 775 (collecting cases). Therefore, there is no need to repeat that exposition here. It is enough to note that, as in *Zoldan,* the parties disagree over whether defalcation must include some element of wrongful intent. "This distinction becomes central to the instant case because" the Surrogate's Court's opinion fails to elaborate on the precise conduct constituting the breach of fiduciary duty. *Id.* "Thus, we are left with the question of whether defalcation can include merely negligent or even innocent default." *Id.*

Creditor argues that the Surrogate's Court's determination that Debtor breached his fiduciary duty demonstrates that Debtor committed a defalcation.[4] Creditor relies principally on *In re*

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[4] The Surrogate's Court's opinion states in pertinent part:

> The proof... supports the petitioner's contention that Hyman exploited the assets of NPS and NPA to obtain profits for himself through the general agency. The Hyman Agency operated out of the same space as Denton-Hyman. It used the NPS[ ] phone number as its own. It used the same "continuum of agents" who carried NPS business cards to sell Guardian products for the general agency. It used NPS and NPA employees to design and administer pension plans, and to train and provide support services to Guardian agents. It used information culled from NPS files to sell additional insurance products to NPS clients. It used NPS to conduct annual seminars and create opportunities for the agents. . . . Finally, Hyman used Denton-Hyman funds to subsidize NPS' operations and to satisfy Hyman Agency debt to the Guardian.

(Stein Decl., Ex. A at 6.)

The Surrogate's opinion goes on to state:

> Hyman breached that duty by co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment. His actions constituted a misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA. The use of NPS and NPA as feeders of new business for the Hyman Agency without compensation constitutes a breach of fiduciary duty .... The use of furniture and fixtures of NPS, NPA and Denton-Hyman by Hyman and the Hyman Agency without compensation also constitutes a breach of fiduciary duty .... The use of Denton-Hyman overrides to subsidize NPS and NPA and to

Hammond, 98 F.2d 703 (2d Cir. 1938), *cert. denied*, 305 U.S. 646 (1939), for the proposition that no wrongful intent is necessary for a defalcation, and therefore the Surrogate's decision on breach of fiduciary duty is sufficient to establish defalcation. In that case, directors of a corporation purchased shares of stock in their own names to enable the corporation to gain access to patents controlled by the company issuing the shares. Those directors then made large profits through the sale of the stock, which they kept for themselves. The Second Circuit found director Hammond liable for breaching his duty of undivided loyalty and his debt nondischargeable because he "misappropriated" funds within the meaning of § 523(a)(4).[5] The Court of Appeals reasoned that because Hammond was chargeable with knowledge of the law concerning fiduciary duty and because his appropriation of the stock profits was intentional, it constituted a misap-

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satisfy Hyman Agency debt to the Guardian is a further breach of fiduciary duty . . . .

(*Id.*, Ex. A at 8-9.)

[5] The relevant statute in 1939, Section 17(a)(4) of the Bankruptcy Act of 1898, excepted from discharge any debts "created by . . . fraud, embezzlement, misappropriation, or defalcation while acting as an officer, or in any fiduciary capacity." The statute in force today, Section 523(a)(4), uses the more limited language "fraud or defalcation"; however, the statute's meaning is not limited by the change. *See The Andy Warhol Found. for Visual Arts, Inc., v. Hayes (In re Hayes)*, 183 F.3d 162, 168 (2d Cir. 1999) ("Although the precise language of the defalcation exception has changed slightly in each major revision of the bankruptcy code, there is wide agreement that its meaning has not." (footnote omitted)).

propriation excepting the debt from release. *See id.* at 705.

However, this Court does not agree with Creditor's broad interpretation of *Hammond.* Creditor fails to acknowledge that the *Hammond* court justified its decision using the reasoning of *Central Hanover Bank & Trust Co. v. Herbst,* 93 F.2d 510 (2d Cir. 1937), where the court "assumed arguendo that 'defalcation' demands some measure of misconduct." *In re Hammond,* 98 F.2d at 706 (summarizing the conclusion of *Central Hanover).* In *In re Zoldan,* this Court analyzed *Central Hanover* in detail:

> Those who advocate a broad interpretation of "defalcation," so as to include innocent or negligent conduct, often cite only one section of Judge Learned Hand's now famous decision:
>
> > Colloquially perhaps the word, "defalcation," ordinarily implies some moral dereliction, but in this context it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts.
>
> *Central Hanover,* 93 F.2d at 511. However, a closer reading of the case reveals Judge Hand's further explanation, implying that some "moral dereliction" might actually be required: "In the case at bar the bankrupt has not been entirely innocent . . . 'defalcation' may demand some portion of misconduct; we will assume arguendo that it does." *Central Hanover,* 93 F.2d at 512.

In re Zoldan, 226 B.R. at 776-77 (footnote omitted). Accordingly, the Court returns to the definition given in *Zoldan:* "Defalcation requires more than mere negligence, and cannot be a completely innocent act. While defalcation may not require actual intent, nor may it rise to the level of misappropriation, it does require some level of mental culpability." *Id.* at 777. In arriving at this conclusion, the Court is mindful "that it is a basic principle of statutory construction that an exception to a debt's discharge should be strictly construed because of the policy of favoring a debtor's fresh start." *Id.* ("Given the ever-expanding definition of what constitutes a 'fiduciary,' to couple this expansion with an equally expansive view of defalcation would defeat the fresh start objective of the bankruptcy law.") (collecting cases). In applying the legal meaning of "defalcation" to the facts of this case, we are mindful that the Bankruptcy Court's legal conclusions are reviewed *de novo* and its factual findings stand unless clearly erroneous.

Although Creditor argues that Debtor's conduct in the instant case was "far more egregious" than the conduct in *Hammond*, this Court is not so persuaded. Debtor's immediate offer to buy out the Estate's interest, three-year-long negotiation over the purchase price and payment of DHA's $1.6 million in debt does not strike this Court as "egregious," certainly not more so than the conduct in *Hammond*. Debtor's conduct throughout was fully consistent with a good faith effort to preserve the business for the mutual benefit of AHA and the Estate.

Nor are we bound by the Surrogate's conclusion that Creditor never consented to or acquiesced to Debtor's continuation of the business. Creditor asserts that the Bankruptcy Court decision is erroneous because it was not entitled to redecide issues surrounding Debtor's state court affirmative defense of consent and acquiescence. In arguing that this issue was conclusively determined at the state court level, Creditor relies on a single sentence in the conclusion section of the Surrogate's Court's opinion where the court stated: "The Court has considered the balance of respondent's arguments and finds them unpersuasive and wholly unsupported by even a sympathetic reading of the testimony and evidence adduced at trial." (Stein Decl., Ex. A at 14; P1.-Appellant Br. at 42.) The Bankruptcy Court questioned the extent to which this language permitted collateral estoppel on an issue decided at best implicitly. (11/15/04 Hr'g Tr. at 18.) As do we. It is not clear to us that the Surrogate's statement extends so far as to eliminate reliance on the negotiation process to disprove defalcation. Having already determined that collateral estoppel does not apply, we cannot say that the Bankruptcy Court's determination regarding Creditor's "knowledge and acquiescence" of Debtor's actions was clearly erroneous given the overwhelming evidence in the record indicating Creditor's acknowledgment of and willingness to allow the continuation of the businesses.

Creditor also relies on *Rothman v. Beeber (In re Beeber)*, 239 B.R. 13 (Bankr. E.D.N.Y. 1999), to establish that a conversion amounting to defalcation occurred. In *Beeber*, conversion of a med-

ical practice constituted a breach of fiduciary duty sufficient to meet the definition of defalcation where one 50% shareholder and doctor in a professional medical corporation converted the practice to his own private practice by, among others, changing the certificate of incorporation to reflect only his name, planning to move the office location, removing all medical records and telling all patients that the office had relocated, all without his partner's consent. *See id. at* 33-34. Creditor finds these facts analogous to the instant situation, and contends that the Surrogate's finding of conversion must constitute defalcation. Indeed, such a conclusion seems correct given the Surrogate's findings indicated above, *see supra* note 4. But *Beeber* arrives at its conclusion for a reason not present in this action. Creditor ignores the fact that *Beeber* made much of Debtor's failure to follow proper corporate procedure, especially the lack of a shareholder vote authorizing the amendment to the certificate of incorporation. *See id.* at 34. Although the court stated that the " 'conversion' . . . was a violation by [debtor] of his fiduciary duty to the corporation," it indicated that the surreptitious conversion was a result of Debtor's failure to buy out the Creditor's share of the medical practice. *See id.*

As already stated, here there were ongoing, arms length negotiations assisted by competent professionals regarding Debtor's purchase of the Estate's shares in DHA, a "defunct" company that terminated upon Denton's death. These good faith negotiations over the proper value for the Estate's shares continued up until Creditor filed the derivative action against DHA.

We find Creditor's remaining cited case law equally unpersuasive. Given our finding that collateral estoppel was inapplicable to the defalcation issue, we cannot say Creditor has established that breach of fiduciary duty as found by the Surrogate is synonymous with defalcation. It is important to note that the Bankruptcy Court—both at the hearing and in its opinion—repeatedly expressed its inability to determine exactly what conduct was wrongful. Judge Hardin stated "[W]hen I first read the motion papers and read . . . the conclusions by the Surrogate I thought this is a slam dunk for the Denton estate. . . . But then when you get beneath that and try to figure out what did he do that was wrong, what else should he have done, I still don't have an answer." (11/15/04 Hr'g Tr. at 13.) Judge Hardin repeatedly asked Creditor's counsel to provide an answer; none was given beyond citation to the Surrogate's Court's opinion that Debtor had co-opted, misappropriated and exploited assets of DHA, NPS and NPA. (10/28/04 Hr'g Tr. at 45, 48, 51, 56, 57.) The Court agrees with Judge Hardin's reaction: "I can read the words . . . but I have difficulty ascribing meaning within the contemplation of the Bankruptcy Code to all the adjectives." *(Id.* at 60.)

Accordingly, this Court, in finding the Surrogate's opinion not dispositive of the issue of defalcation, finds that no defalcation was committed. As Creditor is unable to establish defalcation, we need not decide the issue of fiduciary capacity on this appeal.

CONCLUSION

For the above-listed reasons, the decision of the Bankruptcy Court is affirmed.

SO ORDERED.

Dated: White Plains, New York
November 30, 2005

/s/ William C. Conner
Sr. United States District Judge

FOR PUBLICATION

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Chapter 7
Case No. 03 B 22150 (ASH)

In re:
ANDREW HYMAN,

Debtors.

G. HALLETT DENTON, as Executor of the Estate of George W. Denton,

Plaintiff,

—against—

ANDREW A. HYMAN,

Defendant.

Adv. Proc. No. 04-08536A (ASH)

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ADLAI S. HARDIN, JR.
UNITED STATES BANKRUPTCY JUDGE

CORRECTED SUPERCEDING DECISION DISMISSING CLAIMS BASED ON COLLATERAL ESTOPPEL FOR NON-DISCHARGEABILITY UNDER SECTION 523(a)(2). (4) AND (6) OF THE BANKRUPTCY CODE

Plaintiff G. Hallett Denton, as Executor of the Estate of George W. Denton ("plaintiff," the "Executor" or the "Estate") obtained a pre-petition judgment in the Westchester County Surrogate's Court against defendant/debtor Andrew Hyman (the "debtor" or "Hyman") in the amount of approximately $2.7 million. After Hyman filed for bankruptcy in this Court, plaintiff timely commenced this adversary proceeding seeking (i) an order fixing and allowing the Estate's claim in the debtor's bankruptcy case in the amount of the Surrogate's Court Judgment and (ii) an order and judgment declaring that plaintiff's claim is excepted from the debtor's discharge pursuant to Sections 523(a)(2), (4) and (6) of the Bankruptcy Code.

Plaintiff and the debtor each filed a motion and cross-motion seeking summary judgment. At a final hearing on the cross-motions on November 15, 2004, the Court rendered an oral decision granting in part and denying in part both motions and, following the oral decision, the Court established a schedule of further proceedings leading to a trial on the merits of plaintiff's claim under Section 523(a)(4).

Plaintiff's motion for summary judgment is based on the supposed collateral estoppel effect of the findings of fact and conclusions of law rendered after trial in a written decision by the Sur-

rogate's Court as the predicate for the Surrogate's Court Judgment. In the oral ruling at the November 15, 2004 hearing, this Court concluded that neither the allegations of the complaint nor the Surrogate's Court Decision set forth any factual grounds for a declaration of non-dischargeability under Section 523(a)(2) or (6) of the Bankruptcy Code. On plaintiff's claim under Section 523(a)(4), this Court ruled that because the legal standards for *non-dischargeability* under the Bankruptcy Code are not the same as the state law requirements for *liability*, the findings and conclusions expressed by the Surrogate's Court could not be given preclusive effect as to the materially different legal issues arising under the Bankruptcy Code. Accordingly, both plaintiff and the debtor are entitled to an opportunity to present evidence at a trial necessary to establish, and defend against, plaintiff's claim of non-dischargeability under Section 523(a)(4).

At the November 15 hearing, counsel stated that plaintiff would not rely exclusively on the doctrine of collateral estoppel but would seek an opportunity to establish the facts necessary to support his claim at a trial. Since the November 15 ruling was interlocutory, and since plaintiff's counsel did not fully address the bankruptcy issues framed by the Court during briefing or oral arguments on the motion for summary judgment, the Court established a briefing schedule on the legal issues and did not include in the November 15 oral ruling citation or discussion of the governing legal authorities.

Plaintiff has now moved to withdraw its claims of non-dischargeability under Section 523(a)

other than as may be established by the Surrogate's Court Decision under the doctrine of collateral estoppel, thereby withdrawing and waiving the Estate's right to present evidence at a trial or further argument on the law in support of such claims. Consequently, the Court's November 15 oral ruling and the November 29 order based upon it, which were interlocutory pending further briefing and a trial on the merits, may now be superceded by a final decision and order.

The Court issues this Superceding Decision amplifying the November 15 oral ruling by citation to and analysis of the governing legal authorities, as a basis for a final, and appealable, order concluding this adversary proceeding.

Jurisdiction

This Court has jurisdiction over this adversary proceeding under 28 U.S.C. §§ 1334(a) and 157(a) and the standing order of referral to Bankruptcy Judges signed by Acting Chief Judge Robert J. Ward on July 10, 1984. It is a core proceeding under 28 U.S.C. Section 157(b).

Background

For purposes of the parties' cross-motions for summary judgment, the facts may be briefly summarized based upon the parties' statements of facts and the Surrogate's Court Decision.

In 1984 Hyman and decedent George W. Denton ("Denton) went to work for an insurance agency formed by one Henry Deppe. Deppe's agency was the general agent in Westchester

County of the Guardian Life Insurance Company of America ("Guardian"). Deppe's agency for many years had marketed insurance through pension plans. For this purpose Deppe had formed a separate company to design and administer pension plans called National Pension Services, Inc. The pension business never made a profit but acted as a feeder for the insurance agency, which generated substantial income.

By late 1987 Deppe was ready to retire, and he entered into an agreement to sell his business to Denton and Hyman. Guardian approved both Denton and Hyman together as Guardian's agent for Westchester County under an agreement providing that if either left the business their agency relationship with Guardian would terminate.

Denton and Hyman formed their own agency, the Denton Hyman Agency, and their own pension firm, also called National Pension Services, Inc. ("NPS"). The various agreements were executed on or about January 1, 1988, and Denton and Hyman at that time commenced their business.

The precise terms of the agreements are not relevant here. The bottom line was that Denton and Hyman took over Deppe's business and began their own business as Guardian agents with start-up debts of over $1.6 million owed by the Denton Hyman Agency and NPS, which were personally guaranteed by Denton and by Hyman jointly and severally.

Denton and Hyman each owned fifty percent of the capital stock of the Denton Hyman Agency and of NPS, as well as another company called NPA, which apparently was not a significant economic factor based on the record before me.

As was the case when operated by Deppe, the Denton Hyman Agency generated the profits while the pension business, NPS, acted as a generator or feeder of business for the insurance agency but did not make any money itself. In fact, NPS was always operated at a loss by Deppe, Denton and Hyman, and later by Hyman alone.

Unfortunately, George Denton, who was older and more experienced in the insurance business than Hyman, died suddenly and unexpectedly on February 14, 1989, only thirteen months after Denton and Hyman started their business together.[1] Also unfortunately, Denton and Hyman had no shareholder's agreement or a similar agreement providing for a buyout of the other or what would happen to the business or to the rights and obligations of the shareholders if one died or otherwise left the business.

Several hard facts were quite clear, however. One was that the agency relationship between the Guardian and the Denton Hyman Agency was automatically terminated upon Denton's death. Thus, the Denton Hyman Agency was finished except to pay its debts and collect the residual or override commissions it had earned in the thirteen months of its existence. It had no other material assets. To quote the Surrogate's Court:

> the agency agreement and Guardian policy automatically terminated the relationship between Denton-Hyman and the Guardian on Denton's death, and precluded the Denton

[1] G. Hallett Denton, a lawyer and George Denton's son, was appointed Executor of his father's estate.

estate or Denton-Hyman from becoming a shareholder in the new general agency.

The second hard fact was that Denton's estate and Hyman each were jointly and severally liable for over $1.6 million in debts for which the only source of repayment had been the Denton Hyman Agency relationship with Guardian, which was terminated by Denton's death.

After Denton's death, Guardian accepted Hyman alone as its insurance agent in Westchester, and Hyman formed the Andrew A. Hyman Agency ("Hyman Agency") to serve as Guardian's agent. Hyman continued to operate NPS, which did not automatically terminate as operated by Denton and Hyman, and to fund its deficit operations to serve as a feeder for the Hyman Agency. Hyman formed and operated the Hyman Agency and continued to operate NPS with the full knowledge and acquiescence of the Executor.

Hyman's insurance agency relationship with Guardian terminated in January of 1994 for reasons which are not in the record before me.

The entire $1.6 million debt of the Denton Hyman Agency and NPS was paid off by Hyman, apparently using residual commissions earned by the Denton Hyman Agency in its thirteen months of operation and earnings of the Hyman Agency.

Hyman engaged in lengthy negotiations with the Executor until shortly after termination of Hyman's agency agreement with Guardian regarding a purchase of the Estate's fifty percent interest in the defunct Denton Hyman Agency, NPS and NPA. Both sides were advised in these negotiations by competent professionals. The

negotiations did not result in any agreement, and failure of those negotiations led to the Surrogate's Court proceeding brought by the Executor against Hyman.

In March 1994, the Executor commenced the proceeding in the Surrogate's Court that resulted in the post-trial decision by the Surrogate's Court in December 2002 and subsequent judgment in favor of the Executor against Hyman. Actually, the judgment requires Hyman to pay the $2.7 million not to the Estate but to the Denton Hyman Agency and, according to the Surrogate's Court Decision, the judgment is recompense to the Denton Hyman Agency for profits earned by Andrew Hyman's Agency after George Denton's death.

Unable to pay the judgment, Hyman filed this case under Chapter 11 of the Bankruptcy Code in 2003. The Surrogate's Court judgment was affirmed by the Appellate Division in early 2004. The New York Court of Appeals has rejected an appeal as unripe. This case was converted to Chapter 7 in July 2004 after the Appellate Division affirmed the Surrogate's Court.

Discussion

I. Enforcement of the Surrogate's Court Judgment

The Executor has filed a claim in Hyman's bankruptcy case in the amount of the Surrogate's Court Judgment. As plaintiff in this adversary proceeding, the Executor has asserted in the "Second Claim for Relief" that the Executor is

"entitled to the entry of an order fixing and allowing his claim in the amount of $2,734,832.04, plus such other amounts to be allowed by the Surrogate's Court as set forth above."

Plaintiff's Second Claim for Relief is well founded. This Court does not sit as a reviewing court to examine into the merits of the Surrogate's Court Decision and Judgment. Unless it is upset on appeal, the Surrogate's Court Judgment will be given full force and effect and will be allowed in full as an enforceable claim against the assets of the debtor's estate. The Surrogate's Court analysis of state law, its findings of fact and its ultimate conclusions in applying state law to the facts to determine liability and damages cannot and will not be re-examined or even considered by this Court.

The Surrogate's Court Judgment is entitled to and will be accorded full faith and credit by this Court and will be allowed in full as a claim in this case entitled to receive its *pro rata* share of the assets in the debtor's bankruptcy estate.

The task of this Court in this adversary proceeding is not to determine the debtors liability under state law, as the Surrogate's Court did, but to determine whether the debtor's right to a discharge under the Bankruptcy Code should be denied as a matter of federal law. As amplified below, the issues before this Court are quite different from those which the Surrogate's Court had before it.

Nothing in this decision on dischargeability under federal law may be construed as a comment on the validity or appropriateness under

state law of the Surrogate's Court decision. The Surrogate's Court Judgment will be treated as valid and will be enforced as the Executor's allowed claim in this bankruptcy case.

II. Dischargeability of the Executor's Allowed Claim

After setting forth the background facts including the Surrogate's Court Decision in December 2002 and subsequent judgment entered in April 2003, the complaint in this adversary proceeding alleges in the First Claim for Relief (paragraph 22) that the debtor "is collaterally estopped from contesting [the Surrogate's] findings of fact and conclusions of law" and requests a declaration that plaintiff's claim be excepted from the debtor's discharge pursuant to Sections 523(a)(2), (4) and (6) of the Bankruptcy Code. The Third, Fourth and Fifth Claims for Relief seek declarations of nondischargeability under subsections (2), (4) and (6), respectively, of Section 523(a) on the facts alleged without relying on the collateral estoppel effect of the Surrogate's Court Decision. Since plaintiff has now either abandoned or withdrawn the Estate's claims under the Third, Fourth and Fifth Claims for Relief, plaintiff relies solely on the purported collateral estoppel effect of the Surrogate's Court Decision in seeking to hold the Executor's claim non-dischargeable.

A. Collateral estoppel in bankruptcy proceedings

There is no doubt that the doctrine of collateral estoppel applies in bankruptcy proceedings gen-

erally and in proceedings arising under Section 523(a) of the Bankruptcy Code in particular. *Grogan v. Garner*, 498 U.S. 279, 284 n. 11, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991) ("[C]ollateral estoppel principles do indeed apply in discharge exception proceedings pursuant to § 523(a)"); *In re DeTrano*, 326 F.3d 319, 322 (2d Cir. 2003) ("Where the debt in question is a judgment entered after a claim of fraud has been adjudicated, either party to a subsequent adversary proceeding on nondischargeability can invoke collateral estoppel to establish that the debt is or is not dischargeable under the relevant nondischargeability provision." (citing *Grogan v. Garner*, 498 U.S. 279, 285-91 (1991))); *Zois v. Cooper*, 268 B.R. 890, 893 (S.D.N.Y. 2001), *aff'd*, 73 Fed. Appx. 509 (2d Cir. 2003) ("Collateral estoppel applies in Section 523(a) discharge exception proceedings" (citations omitted)); *see also Perino v. Cohen (In re Cohen)*, 92 B.R. 54, 60 (Bankr. S.D.N.Y. 1988) ("In the Second Circuit, the bankruptcy courts have 'uniformly applied' the doctrine of collateral estoppel to dischargeability proceedings." (citations omitted)); *In re Scheller*, 265 B.R. 39, 57 (Bankr. S.D.N.Y. 2001) ("The Supreme Court has held that collateral estoppel principles apply in proceedings under Section 523(a).") (citing *Grogan v. Garner*, 498 U.S. 279, 284 (1991)); *In re Krautheimer*, 210 B.R. 37, 49 (Bankr. S.D.N.Y. 1997) ("This question was formally answered in *Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991), where the Supreme Court definitively held that collateral estoppel does apply to Section 523(a)

matters. *Id.* at 284-285 n. 11, 111 S.Ct. at 658 n. 11.").

For purposes of the decision in this case, the rule is firmly established by countless federal court decisions that preclusion under collateral estoppel applies only when three conditions are fulfilled: (1) the issue to be decided by this Court must be *identical* to the issue decided by the Surrogate's Court; (2) the identical issue must have been *actually litigated* in the Surrogate's Court; and (3) the issue must have been *actually determined* by the Surrogate's Court Decision and Judgment. *Conte v. Justice*, 996 F.2d 1398, 1400 (2d Cir. 1993) ("Initially, the court must determine whether the issue sought to be litigated is identical to an issue necessarily decided in the prior action and decisive on the present action. (citation omitted) Upon satisfaction of the issue identity requirement, inquiry turns toward whether the party to be bound had a full and fair opportunity to contest the determination now said to control." (citation omitted)). To the same effect, *State of New York v. Sokol* (*In re Sokol*), 113 F.3d 303, 306 (2d Cir. 1997) (". . . New York law provides that the party seeking the benefit of collateral estoppel . . . has the burden of demonstrating the identity of the issues and the necessity of their having been decided, and the party opposing its use . . . has the responsive burden of establishing the absence of a full and fair opportunity to litigate the issue in the prior action." (citing *Kaufman v. Eli Lilly and Co.*, 65 N.Y.2d 449, 455-56, 492 N.Y.S.2d 584, 588, 482 N.E.2d 63, 67 (1985) and *Ryan v. New York Tel. Co.*, 62 N.Y.2d 494, 501, 478 N.Y.S.2d 823, 827, 467

N.E.2d 487, 491 (1984))); *Grogan v. Garner*, 498 U.S. at 284-85 (" . . . a bankruptcy court could properly give collateral estoppel effect to those elements of the claim that are identical to the elements required for discharge and which were actually litigated and determined in the prior action." (citing Restatement (Second) of Judgments § 27 (1982))); *Miskin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 218 B.R. 689, 698 (Bankr. S.D.N.Y. 1998) ("Collateral estoppel precludes relitigation of an issue previously litigated by the parties in federal court if: (1) the issues in both proceedings are identical; (2) the issue in the prior proceeding was actually litigated and actually decided; (3) there was a full and fair opportunity for litigation in the prior proceeding; and (4) the issue previously litigated was necessary to support a valid and final judgment on the merits." (citing *Interoceanica Corp. v. Sound Pilots, Inc.*, 107 F.3d 86, 91 (2d Cir. 1997)) and *Levy v. Kosher Overseers Ass'n of America, Inc.*, 104 F.3d 38, 41 (2d Cir. 1997))); *Zohlman v. Zoldan (In re Zoldan)*, 226 BR. 767, 771 n.5 (S.D.N.Y. 1998) ("The complete, four-part test to establish whether collateral estoppel applies to a prior court's findings is as follows:

(1) The issue sought to be precluded must be identical to that involved in the prior action;

(2) The issue must be actually litigated and actually decided;

(3) There must have been a full and fair opportunity for litigation in the prior proceeding; and

(4) The issue previously decided must have been necessary to support a valid and final judgment on the merits. *See, e.g.*. *Gelb v. Royal Globe Ins. Co.*, 798 F.2d 38, 44 (2d Cir. 1986), *cert. denied*, 480 U.S. 948, 107 S.Ct. 1608, 94 L.Ed.2d 794 (1987).").

Although Hyman claims that a further appeal may be possible to the New York Court of Appeals, for purposes of this decision the Surrogate's Court Decision and Judgment are treated as valid and final.

The question, then, is whether the issues to be decided in this proceeding under Section 523(a)(4) of the Bankruptcy Code are identical to the issues decided by the Surrogate's Court. As will be shown below, the answer to that question is that the issues are not identical, and therefore the rulings of the Surrogate's Court under state law are not preclusive or determinative of the issues that must be decided as a predicate for denial of Hyman's discharge under Section 523(a)(4).

B. Some general observations on the discharge in bankruptcy

It is quite safe to say that the discharge provided under the four operative segments of the Bankruptcy Code, Chapters 7, 11, 12 and 13, lies at the very heart of the Bankruptcy Code. The so-

called "fresh start" provided by the discharge is central to the social policy underlying the bankruptcy laws in this country since the 19th century. *See Wetmore v. Markoe*, 196 U.S. 68, 76, 25 S.Ct. 172, 176, 49 L.Ed. 390 (1904) ("Systems of bankruptcy are designed to relieve the honest debtor from the weight of indebtedness which has become oppressive, and to permit him to have a fresh start in business or commercial life, freed from the obligation and responsibilities which may have resulted from business misfortunes"); *Local Loan Co. v. Hunt*, 292 U.S. 234, 54 S.Ct. 695, 699, 78 L.Ed. 1230 (1934) ("One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.'" (quoting *Williams v. U.S. Fidelity & Guaranty Co.*, 236 U.S. 549, 554, 555, 35 S.Ct. 289, 290, 59 L.Ed. 713 (1915))). Congress reiterated this viewpoint when it passed the Bankruptcy Reform Act in 1978, commenting that discharge is "the heart of the fresh start provisions of the bankruptcy law." *Matter of Martonak*, 67 B.R. 727, 728 (Bankr. S.D.N.Y. 1986) (quoting 11 U.S.C. § 727 no. 595, 95th Cong., 1st Sess. 384 (1977); No. 989, 95th Cong., 2nd Sess. 98 (1978), U.S. Code Cong. & Admin. News 1978, pp. 5787, 5884, 6340). *See also, In re Zoldan*, 221 B.R. 79, 83 (Bankr. S.D.N.Y. 1998), *aff'd*, 226 B.R. 767 (S.D.N.Y. 1998) ("The discharge of debts or 'fresh start' is undoubtedly the philosophical and practical centerpiece of the Bankruptcy Code."); *Rupert v. Krautheimer* (*In re Krautheimer*), 210

B.R. 37, 46 (Bankr. S.D.N.Y. 1997) ("The concept of the discharge is, without question, the 'holy grail' of the Bankruptcy Code. Indeed, it forms the nucleus around which the Code orbits."). The discharge is the centerpiece or "holy grail" sought by all corporate debtors in reorganization and all individual debtors in reorganization or liquidation. It is the *sine qua non* without which there can be no fresh start for the "honest but unfortunate" debtor.

Section 523(a) of the Bankruptcy Code sets forth those circumstances under which dischargeability may be denied in respect of particular debts. Certain subsections of Section 523(a) deny dischargeability of debts arising from conduct of the debtor which was inherently wrongful, illicit or morally reprehensible. Subsections (2), (4) and (6), on which plaintiff in this adversary proceeding relies, are examples, and it is a prerequisite of each that the claim be predicated upon some demonstrably wrongful, illegal or morally reprehensible conduct by the debtor. Regarding Section 523(a)(2)(A), *see In re Gonzalez*, 241 B.R. 67, 71 (S.D.N.Y. 1999) ("To be actionable, the debtor's conduct must involve moral turpitude or intentional wrong; mere negligence, poor business judgment or fraud implied in law (which may exist without imputation of bad faith or immorality) is insufficient." (citations omitted)); *Shearson Lehman Hutton v. Schulman (In re Schulman)*, 196 B.R. 688, 693 (Bankr. S.D.N.Y. 1996) ("Section 523(a)(2)(A) of the Bankruptcy Code provides that a debt is excepted from discharge if it was obtained by 'false pretenses, a false representation, or actual

fraud, other than a statement respecting the debtor's or an insider's financial condition.' The debtor must be guilty of positive fraud or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law which may exist without the imputation of bad faith or immorality." (citations omitted)). Regarding Section 523(a)(4), *see Samuels v. Ellenbogen* (*In re Ellenbogen*), 218 B.R. 709, 716 (Bankr. S.D.N.Y. 1998) ("[M]ere negligence, without some element of intentional wrongdoing, breach of fiduciary duty or other identifiable misconduct, does not constitute 'defalcation' within the meaning of section 523(a)(4)"); *Sandak v. Dobrayel* (*In re Dobrayel*), 287 BR. 3, 16 (Bankr. S.D.N.Y. 2002) (same). Concerning Section 523(a)(6), *see Kawaauhau v. Geiger*, 523 U.S. 57, 61, 118 S.Ct. 974, 977, 140 L.Ed.2d 90 (1998) (The "word 'willful' in [subsection] (a)(6) modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury."); *Navistar Financial Corp. v. Stelluti* (*In re Stelluti*), 94 F.3d 84, 87 (2d Cir. 1996) ("The term 'malicious' means wrongful and without just cause or excuse, even in the absence of personal hatred, spite, or ill-will" (citations omitted)).

Other subsections of Section 523(a) are based upon social policy or the nature of the debt, and not on any form of misconduct or wrongdoing by the debtor, such as subsections (1) (taxes and customs duties), (3) (debts not listed or scheduled), (5) (matrimonial or family debts) and (8) (educational debts).

Because of the crucial importance of the discharge to a debtor in bankruptcy, it follows that non-dischargeability is "perceived to be a punitive exception to the 'fresh start' policy and should be found reluctantly." *Matter of Martonak*, 67 B.R. at 728 (citing *In re Huff*, 1 B.R. 354, 357 (Bankr. D. Utah 1979); *Gleason v. Thaw*, 236 U.S. 558, 35 S.Ct. 287, 59 L.Ed. 717 (1915)).

The courts have repeatedly stressed that the Section 523(a) exceptions to discharge must be strictly construed to comport with the "fresh start" philosophy underlying the Bankruptcy Code. *Household Finance Corp. v. Danns* (*In re Danns*), 558 F.2d 114, 116 (2d Cir. 1977) (interpreting Section 17(a), the predecessor of Section 523) ("[E]xceptions to discharge are to be narrowly construed. . . ." (citations omitted)); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Bonnanzio* (*In re Bonnanzio*), 91 F.3d 296, 300 (2d Cir. 1996); *Shearson Lehman Hutton, Inc. v. Schulman* (*In re Schulman*), 196 B.R. 688, 693 (Bankr. S.D.N.Y. 1996); *Kuper v. Spar* (*In re Spar*), 176 B.R. 321, 326 (Bankr. S.D.N.Y. 1994) ("To meet the goals intended under the Code, exceptions to discharge must be strictly and literally construed against the creditor and liberally construed in favor of the honest debtor" (citations omitted)); *Hudson Valley Water Resources, Inc. v. Boice* (*In re Boice*), 149 BR. 40, 43 (Bankr. S.D.N.Y. 1992) ("Exceptions to dischargeability are construed strictly against the creditor and liberally in favor of the debtor to accomplish bankruptcy's 'fresh start' goal" (citations omitted)).

C. Plaintiff's claims under subsections (2) and (6) of Section 523(a)

Little need be said of plaintiff's purported claims under subsections (2) and (6) of Section 523(a). Subsection (2) denies dischargeability of any debt for money, property, services or credit to the extent obtained by "false pretenses, a false representation, or actual fraud . . ." or "use of a statement in writing" that is materially false, respecting the debtor's financial condition, on which the creditor relied and that the debtor caused to be made or published with intent to deceive. Subsection (6) denies dischargeability "for willful and malicious injury by the debtor" to the person or property of another.

Stated succinctly, there are no allegations of fact in the complaint and no findings of fact or conclusions of law in the Surrogate's Court Decision which would provide any basis for declaring the Executor's allowed claim non-dischargeable under subsections (2) or (6). Plaintiff has effectively abandoned his claims under these subsections, and the debtor is entitled to a final judgment of dismissal with prejudice.

D. The legal issues under Section 523(a)(4)

Plaintiff has relied in this adversary proceeding on Section 523(a)(4), which denies a discharge from any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." The key words here obviously are "defalcation while acting in a fiduciary capacity."

As already noted, plaintiff has chosen to base the Estate's claim exclusively on the Surrogate's

Court Decision and the doctrine of collateral estoppel. The Surrogate's Court conclusions on which the Executor must rely are the following, quoted from pages 8 to 9 of the Surrogate's Court Decision:

> Officers and directors owe a fiduciary duty and an undivided loyalty to their company and its shareholders [citation omitted]. The fiduciary duty is breached when an officer or director misappropriates the assets and goodwill of the corporation [citation omitted] and derives personal profit or benefit at the expense of the corporation [citations omitted]. As a 50% shareholder, officer and director of Denton-Hyman, NPS and NPA, Hyman owed a fiduciary duty to those corporations. Hyman breached that duty by co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment. His actions constituted a misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA. The use of NPS and NPA as feeders of new business for the Hyman Agency without compensation constitutes a breach of fiduciary duty to the corporations for which Hyman and the Hyman Agency are liable. The use of furniture and fixtures of NPS, NPA and Denton-Hyman by Hyman and the Hyman Agency without compensation also constitutes a breach of fiduciary duty to the corporations for which Hyman and the Hyman Agency are liable. The use of Denton-Hyman overrides to subsidize NPS and NPA

> and to satisfy Hyman Agency debt to the Guardian is a further breach of fiduciary duty for which Hyman and the Hyman Agency are liable.
>
> Hyman and the Hyman Agency are accountable and liable for the net profits realized in breach of their fiduciary duty to Denton-Hyman, NPS and NPA [citations omitted].

These are the Surrogate's ultimate conclusions on the issue of liability under state law. They are binding on this Court on the issue of liability under state law and, as already noted, the Surrogate's Court Judgment must be allowed as the Executor's claim in this bankruptcy case.

The question, however, is whether the Surrogate's Court necessarily considered and decided the issues under federal law which must be decided in order to support a finding of nondischargeability under Section 523(a)(4) of the Bankruptcy Code. This requires analysis of the issues arising under subsection (4). As amplified below, there are three basic issues of federal law which must be decided on the issue of dischargeability under subsection (4), not one of which was briefed by the parties or considered by the Court in the Surrogate's Court proceeding. As to each of these issues, federal law on dischargeability may differ significantly from state law on liability.

1. The meaning of "defalcation"

The word "defalcation" used in subsection (4) as interpreted by federal courts is far narrower than the concept of "misappropriation" under state law.

A party may be held liable or accountable under state law for acts or omissions labeled "misappropriation," or "conversion," or "breach of fiduciary duty," done innocently or in good faith, based upon mistake or negligence or simply a disagreement between the parties as to their rights and obligations, with no conscious knowledge of or intent to do wrong. Regarding conversion, Justice Cardozo, formerly Chief Judge of New York, stated in *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333, 55 S.Ct. 151, 79 L.Ed. 393 (1934) that a discharge in bankruptcy "will prevail as against a showing of conversion without aggravated features" and explained that "[t]here may be a conversion which is innocent or technical, an unauthorized assumption of dominion without wilfulness or malice." *Id* at 332. To buttress this point, Justice Cardozo cited to the following cases, among others:

- In *Wood v. Fisk*, 215 N.Y. 233, 241 (1915), stockbrokers repledged a client's stock to procure a loan. The court noted that while the repledge of the collateral for more than the plaintiff's indebtedness was wrong and may have constituted a conversion under New York law, their liability was held to be dischargeable in bankruptcy because based on the facts at issue, the conversion to the extent there was any wilfulness,

was . . . "partial and technical rather than absolute and malicious."

- In *Laverty v. Snethen*, 68 N.Y. 522, 527 (1877), an agent was held liable for conversion for parting with the principal's note in a way or for a purpose not authorized. The court noted that "[t]he question of good faith is not involved. A wrongful intent is not an essential element of the conversion."
- In *Boyce v. Brockway*, 31 N.Y. 490 (1865), where the defendant was found liable for conversion of butter, it was held that "wrongful intent is not an essential element of the conversion" *Id.* at 493. Quoting *Cobb v. Dows*, 9 Barb. 242, the Court explained that there ". . . need not show a tortious taking, or that the defendants acted in bad faith. If it should appear that they obtained the goods fairly from a person whom they had reason to think was the true owner, or if they acted under a mistake as to the plaintiffs' title, or under an honest but mistaken belief that the property was their own, they would still be liable to plaintiffs if their acts in regard to it amount to a conversion. If they have taken it into their own hands, or disposed of it to others, or exercised any dominion over it whatever, they are guilty of a conversion, and their liability to plaintiffs is established." *Id.* (citations omitted).

Similarly, "misappropriation" under New York law may be based upon innocent but mistaken conduct. See *Strough v. Board of Supervisors*, 3 N.Y.S. 110, 112 (Sup. Ct. 1888), *modified on other grounds and affirmed*, 119 N.Y. 212 (1890), in which the defendant was found liable for "illegal, though innocent in intent, misappropriation." This principle extends also to breach of fiduciary duty. Under New York law, corporate fiduciaries may be held liable for breach of fiduciary duty even for conduct undertaken in good faith and innocent intent. As recognized recently in *Matter of Happy Time Fashions, Inc.*, 7 B.R. 665, 670 (Bankr. S.D.N.Y. 1980): "It is well established that directors and officers of a corporation are fiduciaries, and their good faith or innocent motives . . . is [sic] no defense to liabilities founded upon breaches of fiduciary obligations."

By contrast, the drastic remedy of denial of discharge under Section 523(a)(4) requires the proponent to sustain the burden of proof that the debtor knowingly took property belonging to another under circumstances that showed the taking to be wrongful, illegal or otherwise reprehensible and for which he was held liable. As stated by this Court after a review of the decisions in *In re Ellenbogen*, supra, federal courts have consistently held "that, for purposes of Section 523(a)(4) the term 'defalcation' requires at least some element of wrongdoing on the part of the debtor/fiduciary, and that 'innocent' or merely negligent conduct, even if held actionable in a state court, is not within the scope of the statutory exception to dischargeability under the Bankruptcy Code." *In re Zoldan, supra.*

Two decisions of the Court of Appeals for the Second Circuit are instructive on the meaning of "defalcation" under Section 523(a)(4). In the seminal case of *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937) ("*Herbst*"), the debtor, Herbst, was the court-appointed receiver of a parcel of land in foreclosure, and therefore a "fiduciary" under the strictest definition. He was awarded a supplemental fee of $5,674.54 by the lower court, but this award was reversed on appeal. The dissipation of and inability to repay the supplemental fee by Herbst, knowing that this fee was subject to possible reversal on appeal, was held a defalcation by the Court of Appeals. In so holding, Judge Learned Hand said:

> A judge had awarded him the money . . . ; but he knew, or if he did not know, he was charged with notice . . . , that the order would not protect him if it were reversed; and that it might be reversed until the time to appeal had expired. He made no effort to learn from the plaintiff whether it meant to appeal, and he did not wait until it could no longer do so; he took his chances. We do not hold that no possible deficiency in a fiduciary's accounts is dischargeable; in Re Bernard, 87 F.2d 705, 707, we said that "the misappropriation must be due to a known breach of the duty, and not to mere negligence or mistake." Although that word probably carries a larger implication of misconduct than "defalcation," "defalcation" may demand some portion of isconduct; we will assume arguendo that it does.

> All we decide is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a "defalcation" though it may not be a "fraud," or an "embezzlement," or perhaps not even a "misappropriation."

93 F.2d at 512.

In *The Andy Warhol Foundation for Visual Arts, Inc. v. Hayes* (*In re Hayes*), 183 F.3d 162, 171 (2d Cir. 1999), Chief Judge Ralph Winter, after quoting the foregoing excerpt from *Herbst*, said: "Judge Hand's discussion remains the most authoritative explication of the measure of the term [defalcation]. *See Turner*, 134 B.R. at 658 (collecting cases)." In *In re Hayes*, the debtor, Edward W. Hayes, was retained as counsel for the estate of Andy Warhol. Hayes had been paid $4.85 million in fees under a retainer agreement which had been twice amended. Hayes sought additional compensation in the Surrogate's Court over objection by the Executor, and the Surrogate concluded that Hayes' services were worth $7.2 million. On appeal, the Appellate Division reduced Hayes' fee entitlement to $3.5 million. As a result of the Appellate Division judgment, Hayes owed the estate $1.35 million, which judgment was assigned to the Andy Warhol Foundation in August 1986. Shortly thereafter Hayes filed for bankruptcy, and the Foundation timely commenced an adversary proceeding to declare its claim non-dischargeable under Section 523(a)(4).

In ruling that the Foundation's claim was not dischargeable under Section 523(a)(4), Chief Judge Winter said, "... any *ex ante* duty on Hayes's part to account for such fees must be based upon a violation of his fiduciary duty and resultant unreasonableness of his claim of right or title to such funds." He continued:

> [E]ven assuming, as did Judge Hand, that defalcation demands "some portion of misconduct," we hold that Hayes committed a defalcation.
>
> ... Hayes' fee was paid pursuant to an *ex ante* invalid fee agreement that matched fees, not to value of services or even to the value of an estate with assets of stable value, but to a rising art market that had nothing to do with the services he was to perform.
>
> ... Hayes's conduct was inconsistent with his obligation to deal fairly, albeit at a profit to himself, with the estate in establishing a fee arrangement because there was no attempt to match fees and the value of services—even to the extent of imposing a cap on his fees—as required by New York law.... Rather, the payments were pursuant to the invalid fee agreement. Moreover, having arranged a fee agreement that did not match payments to value of services, Hayes chose not to limit his spending to a conservative estimate of what a court might eventually approve or to seek pre-approval of that questionable agreement in New York courts....

> On the facts and circumstances presented, we therefore conclude that Hayes's conduct was sufficiently at odds with his fiduciary obligations to constitute a defalcation within the meaning of Section 523(a)(4) and the gloss put upon it by *Herbst*.

183 F.3d at 172-173.

In short, *Herbst* affirmed and *Hayes* reaffirmed the governing principle in the Second Circuit that the term "defalcation" as used in Section 523(a)(4) demands "some portion of misconduct" on the part of a fiduciary. In *Herbst*, the misconduct consisted in taking for himself, spending and failing to repay funds belonging to the foreclosure estate knowing that his entitlement to the funds was subject to objection and appeal by the beneficiary of the estate. In *Hayes*, the misconduct consisted in the receipt, retention, and failure to repay fees by an attorney-fiduciary pursuant to an unlawful and invalid retainer agreement knowing that the fees in question were subject to objection and appeal by the executor of the estate to which the funds in question belonged.

In this case, for obvious reasons, neither the parties nor the court in the Surrogate's Court proceeding considered or had occasion to consider the restrictive definition of "defalcation" under the Bankruptcy Code or the differences between Section 523(a)(4) defalcation and state law concepts of misappropriation. Nowhere does the word "defalcation" appear in the Surrogate's Court Decision. Given the material differences between the meaning of "defalcation" under fed-

eral bankruptcy law and the concepts of misappropriation and breach of fiduciary duty under state law, it simply cannot be said that the federal question at issue in this adversary proceeding was considered and decided in the Surrogate's Court proceeding.

This conclusion is underscored when one attempts to understand what it was that Hyman did or did not do after Denton's death that could fairly be characterized as a defalcation, or as intentionally wrongful, illicit or reprehensible, such as to justify denial of Hyman's discharge. *There is no finding of fact by the Surrogate, and no claim by the plaintiff in this adversary proceeding, that Hyman took money or property of Denton-Hyman Agency NPS or NPA without accounting for it—i.e. no claim of defalcation in the ordinary dictionary sense of that word.*

Nor is it clear what Hyman did that could be characterized as "misconduct" within the scope of the *Herbst* and *Hayes* decisions. What Hyman actually did after Denton's death was to seek his individual appointment as Guardian's agent in Westchester and to organize his own agency to carry on the insurance business. That surely was not wrongful in any respect, since Denton was dead and Guardian forbade the former Denton-Hyman Agency to continue in the business. The Executor had knowledge of these facts and acquiesced in Hyman's continuation of the insurance business by himself in his own name, with no further contribution of time and effort, capital or risk by the Denton-Hyman Agency or the Denton Estate. Hyman also continued to operate (and fund the operating deficit) of NPS and NPA, at

no cost in time, effort, money or risk to the Denton Estate as the other 50% shareholder. This was not wrongful in any respect, and the Executor acquiesced in this also with full knowledge of what Hyman was doing. That the Executor acquiesced in Hyman's continuation of the "enterprise" is not surprising since it enabled Hyman to generate sufficient income to pay off the entire $1.6 million indebtedness of the Denton-Hyman Agency and NPS, for which both Hyman and the Denton Estate were jointly and severally liable.

In addition to the foregoing, Hyman engaged in protracted negotiations with the Executor from 1989 until 1993 or early 1994 with respect to a buy-out of the Denton Estate's interest in the defunct Denton-Hyman Agency, NPS and NPA. The parties did not reach agreement in their negotiations, and as a consequence the Executor commenced the proceeding against Hyman in the Surrogate's Court. But the fact that the negotiations failed, and that the Surrogate's Court ultimately ruled that the Denton-Hyman Agency was entitled to be paid a portion of Hyman Agency profits, does not mean that Hyman engaged in a "defalcation" under any definition of that term. While it appears that Hyman utilized residual commissions of the Denton-Hyman Agency to repay in whole or in part (the record before this Court is unclear) the $1.6 million indebtedness of the Denton-Hyman Agency, NPS and NPA, it bears repeating that there is no finding of fact or conclusion in the Surrogate's Court Decision that Hyman misappropriated to himself any money or property belonging to the Denton-Hyman Agency, NPS or NPA, the three corporate entities of

which Hyman could be said to be a fiduciary as an officer and director. The damages assessed against Hyman by the Surrogate were not on account of funds belonging to and taken from the Denton-Hyman Agency, NPS or NPA, but represented a share of profits earned *by Hyman's own agency* formed after Denton's death. This is in sharp contrast to the defalcation found in *Herbst* and *Hayes*, which involved the fiduciary's taking of and failure to repay funds belonging to the entity of which he was a fiduciary. No such finding appears in the Surrogate's Court Decision.

As shown in the passage from pages 8-9 of the Surrogate's Court Decision quoted above, what Hyman did that the Surrogate's Court found to be wrongful was "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment . . . *without compensation* . . ." (emphasis supplied). What the Surrogate characterized as a breach of fiduciary duty was Hyman's failure to compensate the Denton-Hyman Agency for carrying on the "enterprise" which had been established by Denton and Hyman before Denton's death. This failure was no more nor less than the failure of the negotiations which were carried on between Hyman and the Executor from 1989 until late 1993 or early 1994 with respect to a buy-out by Hyman of the Denton Estate's 50% interest in the "enterprise" carried on for thirteen months by the Denton-Hyman Agency, NPS and NPA.

Undoubtedly there were reasonable, good faith grounds for each side to dispute the compensable value of the "enterprise." After all, Denton had

died and could no longer contribute anything to the business; the Denton Hyman Agency was barred from further participation in the business, and its only assets (the residual commissions earned in its thirteen months in business) may have been used in whole or in part to pay off the $1.6 million debt of the "enterprise;" and the other corporate entities in which the Estate had a 50% interest, NPS and NPA, had negligible assets and never earned a profit. But reasonable or not, the refusal of Hyman to agree to the Executor's demands was not a defalcation and should not result in denial of dischargeability.

During oral argument on the summary judgment motions, this Court repeatedly asked the attorneys for plaintiff, including the Executor's counsel in the Surrogate's Court proceeding, to specify precisely what it was that Hyman did that was illicit, morally reprehensible or otherwise wrongful, other than the fact that he ultimately did not reach agreement with the Executor as to the amount to be paid in a buy-out of the Denton Estate's 50% interest in Denton-Hyman Agency, NPS and NPA. Stated differently, the Court asked counsel what it was that Hyman should have done differently after Denton's death, other than failing to reach agreement in the buy-out negotiations. Despite repeated opportunities to answer these questions, plaintiff's counsel never identified any specific conduct on the part of Hyman which could be characterized as a defalcation, or any conduct of any kind that was wrongful, illegal or morally reprehensible, other than the fact that the par-

ties ultimately did not reach agreement on a buy-out. Nor did the Surrogate in his Decision.

There is, in short, nothing in the complaint or in the record before this Court and nothing in the Surrogate's Court Decision which could fairly be said to constitute a "defalcation" within the meaning of Section 523(a)(4) of the Bankruptcy Code, as expounded in *Herbst*, *Hayes* and countless other federal court decisions.

2. The restricted concept of "fiduciary capacity"

The Surrogate's Court held that under New York corporate law Hyman, as an officer and director of the Denton-Hyman Agency, NPS and NPA, had a "fiduciary duty" to the other 50% shareholder of each of these corporate entities. But as stated by this Court in *In re Dobrayel*, 287 B.R. at 14, "[t]he meaning of 'fiduciary capacity' under Federal laws is more restricted than under the more general common law or state law definitions."

The meaning of "fiduciary capacity" under Federal laws is narrower than under the more general common law or state law definitions. *Stone v. Stone* (*In re Stone*), 94 B.R. 298, 302 (S.D.N.Y. 1988), *aff'd*, 880 F.2d 1318 (2d Cir. 1989); *In re Midkiff*, 86 B.R. 239, 241 (Bankr. D. Cob. 1988); *Anderson v. Currin* (*In re Currin*), 55 B.R 928, 932 (Bankr. D. Colo. 1985); *In re Zoldan*, 221 B.R. at 84 ("The concept of fiduciary under Section 523(a)(4) . . . is far narrower in scope than under state law"). Under Section 523(a)(4), "fiduciary capacity" applies only to technical or express trusts and not to trusts ex maleficio.

Davis v. Aetna Acceptance Co., 293 U.S. 328, 333, 55 S.Ct. 151, 79 L.Ed. 393 (1934); *In re Dobrayel*, 287 B.R. at 14; *In re Scheller*, 265 B.R. at 52 (citations omitted); *NesSmith Electric Co., Inc. v. Kelley* (*In re Kelley*), 84 B.R. 225, 229 (Bankr. M.D. Fla. 1988) (same); 4 COLLIER ON BANKRUPTCY, ¶ 523.10[1][c], p. 523-72 (15 ed. rev. Rel. 65-3/98). "Such technical or express trusts must exist prior to and independently of the wrongful conduct giving rise to the claim of non-dischargeable debt." *In re Dobrayel*, 287 B.R. at 14 (citations omitted). *But see also LSP Inv. Partnership v. Bennett* (*In re Bennett*), 989 F.2d 779, 784-85 (5th Cir. 1993), *cert. denied*, 510 U.S. 1011, 114 S.Ct. 601, 126 L.Ed.2d 566 (1993) ("There has been some disagreement among the courts as to what exactly is meant by the requirement that there be a 'technical trust' to satisfy section 523(a)(4). Most courts today, however, recognize that the 'technical' or 'express' trust requirement is not limited to trusts that arise by virtue of a formal trust agreement, but includes relationships in which trust-type obligations are imposed pursuant to statute or common law.").

While the definition of fiduciary capacity is a matter of Federal law, state law may be consulted in determining whether and when express or technical trusts exist in "this strict sense." *In re Scheller*, 265 B.R. at 52 ("State law is to be consulted to determine when a trust in this strict sense exists") (citing *Zohlman v. Zoldan*, 226 B.R. at 773); *Ragsdale v. Haller* (*In re Ragsdale*), 780 F.2d 794, 796 (9th Cir. 1986) ("Although the concept of fiduciary is to be narrowly defined as a matter of federal law, state law is to be con-

sulted to determine when a trust in this strict sense exists." (citation omitted)); *Krishnamurthy v. Nimmagadda* (*In re Krishnamurthy*), 209 B.R. 714, 722 (9th Cir. BAP 1997), *aff'd*, 125 F.3d 858 (9th Cir. 1997), *cert. denied*, 524 U.S. 930, 118 S.Ct. 2328, 141 L.Ed.2d (1998) (determining whether the relationship is fiduciary under Section 523(a)(4) is an issue of Federal law for which state law can be consulted). However, the applicable state law that creates a fiduciary relationship must clearly enumerate the fiduciary duties and identify the trust res. *See Johnson v. Woldman*, 158 B.R. 992, 996 (ND. Ill.1993), *aff'd*, 92 F.3d 546 (7th Cir. 1996).

As stated by the Court of Appeals in *Hayes*,

> It has been clear, at least since 1841, that the defalcation exception is not limited to express trusts, *i.e.*, situations where a trustee is a beneficial owner of a *res* held and managed for a named beneficiary. Indeed, the act stated as much in specifying "executor[s], administrator[s], guardian[s] or trustee[s]" and then adding others "acting in any other fiduciary capacity." Moreover, Section 4 of the same act provided that "no person should be entitled to a discharge who should 'apply trust finds to his own use.'" *Hennequin v. Clews*, 111 U.S. 676, 679, 4 S.Ct. 576, 28 L.Ed. 565 (1884) (quoting ch. IX, § 4, 5 Stat. 441).

Although recognizing that "fiduciary" covers more than express or formal trust relationships, Chief Judge Winter in *Hayes* reaffirmed the principle that the fiduciary relationship must exist

before the defalcation giving rise to liability. Discussing the Supreme Court decision in *Davis v. Aetna Acceptance Corp.*, 293 U.S. 328 (1934), Chief Judge Winter said:

> . . . . Justice Cardozo, writing for the Court, quoted *Chapman's* language that "the statute 'speaks of technical trusts, and not those which the law implies from the contract.'" *Id.* at 333, 55 S.Ct. 151 (quoting *Chapman*, 43 U.S. at 208). His concern was the same as that expressed in *Chapman*—that the act not be construed so as to except from discharge normal commercial debts. To this end, he explained:
>
> > It is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee ex maleficio. He must have been a trustee before the wrong and without reference thereto. . . . "The language would seem to apply only to a debt created by a person who was already a fiduciary when the debt was created."
>
> *Id.* (quoting *Upshur v. Briscoe*, 138 U.S. 365, 378, 11 S.Ct. 313, 34 L.Ed. 931 (1891)).

The requirement of a pre-existing fiduciary relationship and the rejection of the notion of a trustee *ex maleficio* as a basis for non-dischargeability under Section 523(a)(4) obviously were not issues presented to or considered by the Surrogate's Court, although, as amplified below,

these issues are vital to a determination of non-dischargeability under the Bankruptcy Code.

3. The limitation "while acting," in a fiduciary capacity

Accepting the proposition that a corporate officer or director may be deemed a "fiduciary" with respect to his stewardship of corporate property within the meaning of Section 523(a)(4), that alone is not sufficient to hold a debt non-dischargeable under subsection (4). The statute applies only to a debt incurred on account of conduct, a defalcation, perpetrated while the debtor was acting in the fiduciary capacity in question. As this Court explained in *Zolman v. Zoldan* (*In re Zoldan*), 221 B.R. 79, 87 (Bankr. S.D.N.Y. 1998), *aff'd*, 226 B.R. 767 (S.D.N.Y. 1998).

> The mere *existence* of a fiduciary relationship is not sufficient to deny dischargeability under Section 523(a)(4). The Court must also make a finding that the debtor-defendant was "*acting* in a fiduciary capacity" with respect to the particular conduct giving rise to the liability which is claimed to be non-dischargeable.

(emphasis in original). *See Otto v. Niles* (*In re Niles*), 106 F.3d 1456, 1459 (9th Cir. 1997) (The plaintiff-creditor must demonstrate that "the debtor acted as a fiduciary to the creditor at the time the debt was created.") (quoting *Klingman v. Levinson*, 831 F.2d 1292, 1295 (7th Cir. 1987)); *Matter of Koszuth*, 43 B.R. 104, 107-108 (Bankr. Fla. 1984) (citing *Intercontinental Life Ins. Co. v. Good* (*In re Good*) 33 B.R. 163 (Bankr. M.D. Fla.

1983) ("In the context of § 523(a)(4) the creditor must not only establish that the wrongful act gave rise to personal liability but also that the Debtor performed the wrongful act while acting in a fiduciary capacity."); *Rosen v. Rosen* (*In re Rosen*), 232 B.R. 284, 296 (Bankr. E.D.N.Y. 1999) ("If a fiduciary relationship did exist, the second step is to examine if fraud or defalcation occurred during that relationship.").

Hyman was not held liable by the Surrogate for any defalcation or other conduct "while acting" in his capacity as a director and officer of any of the corporate entities involved. Indeed, as already noted, there is no finding by the Surrogate and no allegation by plaintiff of any defalcation at all, *i.e.*, no taking by Hyman for his own unaccounted-for use of funds of the three corporate entities in which the Denton Estate had a 50% interest.

Nor is there any finding of fact in the Surrogate's Court Decision to the effect that Hyman did anything that was wrongful, illegal or morally reprehensible "while acting" in his capacity as an officer and director of the Denton-Hyman Agency, NPS, NPA or his own Hyman Agency. The Surrogate did not find (and plaintiff has not argued) that it was a breach of fiduciary duty or wrongful for Hyman to become Guardian's insurance agent for Westchester County after Denton's death, or to form and operate the Hyman Agency as successor to the Denton-Hyman Agency, or to continue the use of NPS and NPA as feeders for the Hyman Agency, and there is no dispute that the Executor had full

knowledge of and acquiesced in Hyman's conduct in so doing.

The Executor has never claimed that Hyman committed any breach of duty in his conduct as an officer and director of Denton Hyman Agency, NPS or NPA. Plaintiff's counsel acknowledged in this proceeding the obvious fact that the Surrogate's Court proceeding was brought only because the Executor's lengthy and difficult negotiations with Hyman for a buyout of the Estate's 50% interest in the "enterprise" did not result in agreement. And the Surrogate's Court found Hyman liable solely because he did not reach agreement to compensate the Estate for a buyout of the Estate's 50% interest, and not for any breach of duty in his capacity as an officer and director of the three entities.

The point here is that Hyman *was not acting as a fiducicary* for the Denton Estate in the buyout negotiations. The Executor was the fiduciary acting for the Estate in those negotiations, and Hyman was the adversary.

Aside from the lack of any defalcation, the fatal defect in plaintiff's theory under Section 523(a)(4) is that Hyman was not acting in the capacity of a fiduciary in connection with the negotiations for a buy-out. Those negotiations were conducted at arm's length, between parties with adverse interests and conflicting views as to the proper compensation to be paid by Hyman to the other 50% shareholder, with each side being represented by competent professionals. The relationship of two parties engaging in arm's length negotiations with respect to the purchase and sale of an asset or an interest is never fidu-

ciary—it is adverse and conflicted. The failure to reach an agreement in such a negotiation is a failure of both sides, and does not represent breach of a trust or a trust relationship under the Bankruptcy Code. The fact that a court may ultimately resolve the parties' dispute in the context of a litigation does not mean that the losing party is to be deemed guilty of wrongdoing, much less a defalcation, "while acting in a fiduciary capacity" within the meaning of Section 523(a)(4) of the Bankruptcy Code.

III. Summary Judgment and the Right to a Trial

As noted at the outset, this matter came before the Court on cross-motions for summary judgment. With respect to plaintiff's claim under Section 523(a)(4) based on collateral estoppel, this Court ruled at the November 15 hearing only that the Surrogate's Court Decision did not consider the issues or contain findings and conclusions required under the Bankruptcy Code. In the interlocutory ruling on November 15, this Court did not grant judgment against plaintiff on the merits, but simply denied both cross-motions, ruling that both sides should have the opportunity to present evidence at a trial on the Section 523(a)(4) claim. There are sharply contested issues of fact requiring a trial on the claims under Section 523(a)(4), and both plaintiff and defendant are entitled to a day in court, this

Court, on the bankruptcy issues not considered or decided in the Surrogate's Court.[2]

However, subsequent to the November 15 hearing, plaintiff has waived the Estate's right to a trial. He has thereby deprived Hyman of the right to present rebuttal evidence at a trial on the hotly disputed factual issues regarding the existence or not of a defalcation, whether there was "some portion of misconduct" in any of Hyman's acts or omissions, and whether Hyman committed any defalcation or misconduct in his capacity as a fiduciary of the three jointly-owned corporate entities, as opposed to his capacity as an adverse party negotiating at arm's length the price of a buy-out with the Executor.

Plaintiff has thus chosen to rely exclusively on the Surrogate's Court Decision to sustain the Estate's heavy burden to deny Hyman's statutory right to discharge on the Denton Estate's claim. It is a burden the Decision cannot sustain because the bankruptcy issues were not litigated in the Surrogate's Court.

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[2] By contrast, in *Rothman v. Beeber (In re Beeber)*, 239 B.R. 13 (Bankr. E.D.N.Y. 1999), cited by plaintiff, the Bankruptcy Court rendered decision on a Section 523(a)(4) claim and many other issues after a full trial on the merits in the Bankruptcy Court. The Section 523(a)(4) claim was granted based on a litany of admitted "facts regarding the Debtor's use of funds of the corporation for his personal expenses; . . ." 239 B.R at 32 *et seq*. No such findings appear in the Surrogate's Court Decision.

Conclusion

The legal standards for a finding of liability under New York State law, as articulated in the Surrogate's Court Decision, are quite different from the legal and factual requirements for a determination of non-dischargeability under Section 523(a)(4) of the Bankruptcy Code. The Surrogate's Court was not presented with and did not decide the legal issues which must be resolved to determine a claim for non-dischargeability under Section 523(a)(4). The Surrogate's Court Decision does not contain findings of fact and conclusions of law necessary to support denial of dischargeability of the Executor's claim in the debtor's bankruptcy case under the doctrine of collateral estoppel. Accordingly, plaintiff's claims under Section 523(a) based on collateral estoppel must be dismissed. The Court will enter an appropriate order finally disposing of this adversary proceeding.

Dated: White Plains, NY
January 21, 2005

/s/Adlai S. Hardin, Jr.
U.S.B.J.

[LETTERHEAD OF UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT]

Filed October 23, 2007

Date:
DC Docket Number: 05-cv-2867
Docket Number: 05-7026-bk
DC: SDNY (WHITE PLAINS)
Short Title: In Re: Andrew A. Hyman v.
DC Judge: Honorable William Conner

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Daniel Patrick Moynihan United States Courthouse, 500 Pearl Street, in the City of New York, on the 23rd day of October two thousand seven.

In re: Andrew A. Hyman

A petition for panel rehearing and a petition for rehearing en banc having been filed herein by the appellant G. Hallett Denton. Upon consideration by the panel that decided the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the petition for rehearing en banc has been transmitted to the judges for the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

For the Court:

Catherine O'Hagan Wolfe, Clerk

By: /s/ [Illegible]
Motion Staff Attorney

SURROGATE'S COURT:
WESTCHESTER COUNTY

File No. 719/1989

Application of G. Hallett Denton,
as Executor of the Estate of
GEORGE W. DENTON,
Deceased,

To Discover Personal Property
Withheld and Belonging to Decedent.

DECISION

SCARPINO - S.

In this shareholder derivative claim brought pursuant to SCPA 2103, the decedent's estate, as a 50% shareholder of three corporations, seeks to recover from the decedent's business partner, Andrew Hyman ("Hyman") and the Andrew A. Hyman Agency (the "Hyman Agency"): (i) profits earned by Hyman and the Hyman Agency in exploiting the assets of these corporations; (ii) damages suffered as a result of the diversion of

corporate assets, and (iii) the imposition of a constructive trust. The respondent asserted a number of defenses including statute of limitations, ratification and estoppel. In addition, the respondent asserted a counterclaim for alleged loans to the estate and two of its beneficiaries.

The issues raised in this proceeding were tried before the Court in April and May, 2002. The Court makes the following Findings of Fact and Conclusions of Law.

In 1987, the decedent and the respondent organized the Denton-Hyman Agency, of which they were the sole and equal shareholders for the purpose of acquiring from Henry A. Deppe ("Deppe") the pension administration business of National Pension Services, Inc. ("NPS"), National Pension Actuaries, Inc. ("NPA") and the business of the Henry A. Deppe General Agency, which, at the time, was the general agent of the Guardian Life Insurance Company (the "Guardian") in Westchester County. The decedent and Hyman were also equal 50% shareholders of NPS and NPA. The decedent and Hyman were president and vice-president respectively as well as board members of each corporation. NPS was set up primarily to design and administer defined benefit pension plans that were funded to some degree with life insurance. The Denton-Hyman Agency was the beneficiary of the premiums earned on life insurance that was sold within those plans. NPA was set up to design and administer primarily non-insured pension plans.

George W. Denton died unexpectedly on February 14, 1989, and his son, the petitioner, was appointed executor of his estate on March 13, 1989.

On February 15, 1989, Hyman succeeded the decedent as president and sole director of the three corporations. Also on February 15, 1989, Hyman entered into negotiations with the Guardian on behalf of the newly created, and wholly owned, Andrew A. Hyman Agency, to succeed Denton-Hyman as its successor general agent in Westchester County. The negotiations were concluded in October 1989 and the Hyman Agency thereupon succeeded Denton-Hyman as successor general agent for the Guardian. The general agency agreement was made retroactive to February 15, 1989.

After the death of George Denton, NPS and NPA continued to act as pension plan administrators and designers. In addition, the Hyman Agency, through an existing network of brokers and agents, continued to use NPS and NPA to design pension plans that were then funded with life insurance and other Guardian products. In effect, nothing changed, with the singular exception that premiums earned on the sale of Guardian products were paid to the Hyman Agency, not to Denton-Hyman. This circumstance continued until January 1994 when the Hyman Agency was replaced as the Guardian's general agent. Coincident with this event, Hyman resigned as president of NPS and NPA and was succeeded by Michael Donahue, an employee of the companies. Hyman remained the sole director of NPS, NPA and Denton-Hyman and retained his 50% shareholder interest with the estate of Denton in each company. The business of NPS and NPA continued until April 2002 when its operations were outsourced to another firm.

The petitioner contends that NPS, NPA and Denton-Hyman operated as a common enterprise in which NPS and NPA provided the Agency with access to a captive market for the lucrative sale of life insurance and other insurance products to companies and their employees. Petitioner also contends that Hyman exploited the assets of Denton-Hyman, NPS and NPA by using NPS and NPA as feeders and marketing tools to obtain profits for himself through the Hyman Agency and by using the receivables of Denton-Hyman to subsidize NPS' operations and satisfy its debt. Petitioner seeks to recover $3.6 million in profits from Hyman for breach of his fiduciary duty to the corporations. In the alternative, petitioner seeks to recover the damages suffered by Denton-Hyman as a result of the diversion of its assets.

Hyman denies that he breached a fiduciary duty to the corporations. He contests the allegation that NPS, NPA and Denton-Hyman functioned as a common enterprise and contends instead that NPS and NPA are stand alone corporations in the pension design and administration industry. He further contends that a provision in the contract between the Guardian and Denton-Hyman automatically terminated the general agency upon the death of George Denton. Given this fact, he claims that the formation of the Hyman Agency was proper under the circumstances. He also claims that the continued operation of NPS was essential to protect the future stream of override commissions that were needed to satisfy a substantial corporate debt that he and the decedent had personally guaranteed.

Finally, Hyman claims that his actions were known to the petitioner and ratified by him.

The proof supports petitioner's contention that Denton-Hyman, NPS and NPA functioned as a common enterprise in which the profits of the enterprise would be derived from the commissions earned by the general agent from Guardian products sold to fund the pension plans designed by NPS and NPA. In this regard, the Court credits the testimony of Deppe that he created NPS in 1957 to provide a marketing device for agents to sell insurance products. His business plan envisioned that insurance agents would market themselves as pension consultants thus providing ready access to clients who were otherwise less accessible to the typical insurance or investment consultant. Each agent was required to carry an NPS card, not a Guardian Insurance card or a card of the Deppe Insurance Agency, as would otherwise be the case. As Deppe testified, the sale of insurance products to fund pension plans designed by NPS was lucrative for the agent and the general agency. In each instance, the agent received a commission of 50% of the first years premium while the general agency received an "override" commission of 5% plus a substantial expense reimbursement allowance. In addition, each received renewal commissions for nine years. The agent and the general agency also received "adds" and "additions". These were premiums that accrued automatically when additional insurance was added to the pension plan as the company's workforce grew and its payroll increased. NPS also maintained a "census" of each company's employees that it made available

to the agents. The census was a fundamental prospecting tool for the sale of other group benefits and individual insurance products to the company and its employees, thus providing additional revenue for the general agent. Indeed, Deppe testified that his agency derived 75 to 80% of its business from NPS clients and considered NPS to be essential to the agency's success in this area.

NPS and NPA were not profit centers. The record reflects that both consistently lost money. Deppe testified that it was important for NPS to price itself under market to provide revenue for the general agency. According to Deppe, he told Denton and Hyman, during their negotiations, that NPS was a loss leader that needed to be subsidized.

Anthony Domino, Sr. ("Domino") also testified regarding the relationship between NPS and the general agency. Domino was a "producer" who sold insurance products through the Deppe Agency, Denton-Hyman and the Hyman Agency between 1983 and 1994. Like other insurance agents affiliated with Denton-Hyman and later with the Hyman Agency, Domino carried an NPS business card and marketed himself as a pension consultant affiliated with NPS. He testified that until 1994 when the Hyman Agency severed its relationship with the Guardian, NPS was still an invaluable tool for the marketing of Guardian products. In fact, between 1989 and 1994, 100% of Domino's $1 million annual income was derived through the use of NPS as a marketing tool. Hyman's own testimony emphasized the importance of NPS to the general agency. Hyman

testified that he would not have agreed to become the Guardian's general agent unless he was able to purchase NPS and NPA.

The proof also supports the petitioner's contention that Hyman exploited the assets of NPS and NPA to obtain profits for himself through the general agency. The Hyman Agency operated out of the same space as Denton-Hyman. It used the NPS' phone number as its own. It used the same "continuum of agents" who carried NPS business cards to sell Guardian products for the general agency. It used NPS and NPA employees to design and administer pension plans, and to train and provide support services to Guardian agents. It used information culled from NPS files to sell additional insurance products to NPS clients. It used NPS to conduct annual seminars and create opportunities for the agents. Indeed, the NPS brochure features photographs of many Hyman Agency leading insurance producers as members of the NPS organization. Finally, Hyman used Denton-Hyman funds to subsidize NPS' operations and to satisfy Hyman Agency debt to the Guardian. A 1987 change in the tax law regarding pension life insurance does not alter this result. As Domino testified, the legislation caused a shift from the sale of pension life insurance to other Guardian equity products, however, as late as 1994, NPS was still an invaluable marketing tool.

The proof does not support Hyman's contention that Denton-Hyman and the decedent's estate were precluded under all circumstances from participating in the Hyman Agency or sharing in the benefits of the Hyman Agency's continued rela-

tionship with the Guardian. Admittedly, the Agency Agreement and Guardian policy automatically terminated the relationship between Denton-Hyman and the Guardian on Denton's death, and precluded the Denton estate or Denton-Hyman from becoming a shareholder in the new general agency. Nevertheless, Hyman made no effort to explore other options (such as a sharing or assignment of commissions between the Hyman Agency and Denton-Hyman) to preserve the corporate interest of Denton-Hyman in Guardian business. Timothy Lavey, an officer of the Guardian, testified that the Guardian would not have objected to such an arrangement. Indeed Hyman subsequently assigned Hyman Agency commissions to Benefit Technologies, Inc. ("BTI"), another insurance related business that he has a shareholder interest in.

In addition, the proof does not support Hyman's contention that the continued operation of NPS was essential to protect and maximize the future stream of Denton-Hyman override commissions. The argument is premised upon the assertion that without NPS, a new plan administrator or broker would rewrite existing Guardian policies in order to earn commissions for the new agency. Deppe testified that such a concern was unrealistic since any attempt to rewrite existing policies would constitute illegal "twisting". In fact, neither Denton-Hyman nor the Hyman Agency saw a drop in override commissions when one-third of NPS' clients transferred to the new pension firm organized by Howard Rosenfeld, NPS' former chief actuary. Indeed, when Hyman recently outsourced NPS'

operations to a competitor, Hyman made no special arrangements to preserve Hyman Agency overrides.

Finally, the proof does not support Hyman's contention that NPS and NPA had no value as going concerns. In this regard, the Court credits Deppe's testimony that NPS and NPA could have been sold after Denton's death to another general agency despite its history of unprofitability. Indeed, Denton and Hyman paid Deppe more than $600,000 for the two companies in 1987 at a time when it had more than 1000 clients, and was, in Hymans' own words, a break even operation. In 2002, after NPS and NPA had sustained fifteen years of consecutive losses and lost nearly one-third of its client base, Hyman was still able to outsource the companys' operations for $500,000 with the possibility of additional proceeds.

Officers and directors owe a fiduciary duty and an undivided loyalty to their company and its shareholders (*Schachter v Kulik*, 96 Ad2d 1038). The fiduciary duty is breached when an officer or director misappropriates the assets and goodwill of the corporation (*Matter of Greenberg*, 206 AD2d 963) and derives personal profit or benefit at the expense of the corporation (*Schachter v Kulik, supra*; *Fender v Prescott*, 101 AD2d 418). As a 50% shareholder, officer and director of Denton-Hyman, NPS and NPA, Hyman owed a fiduciary duty to those corporations. Hyman breached that duty by co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment. His actions constituted a mis-

appropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA. The use of NPS and NPA as feeders of new business for the Hyman Agency without compensation constitutes a breach of fiduciary duty to the corporations for which Hyman and the Hyman Agency are liable. The use of furniture and fixtures of NPS, NPA and Denton-Hyman by Hyman and the Hyman Agency without compensation also constitutes a breach of fiduciary duty to the corporations for which Hyman and the Hyman Agency are liable. The use of Denton-Hyman overrides to subsidize NPS and NPA and to satisfy Hyman Agency debt to the Guardian is a further breach of fiduciary duty for which Hyman and the Hyman Agency are liable.

Hyman and the Hyman Agency are accountable and liable for the net profits realized in breach of their fiduciary duty to Denton-Hyman, NPS and NPA (*Birnbaum v Birnbaum*, 157 AD2d 177; *Sialknot Importing Corp. V Berlin*, 295 NY 482; *Blakeslee v Sottile*, 118 Misc 513). According to petitioner's expert witness, Bernard Kleinman, Hyman obtained over $3.6 million in profits between 1989 and December 2000. Kleinman testified that when the Hyman Agency, NPS and NPA are considered together as a single enterprise, that enterprise generated $2,470,144 in profits to Hyman through 1994. In addition, Hyman collected override commissions from 1995 through 2000 totaling $1,184,717 on products sold through the Hyman Agency prior to 1995. In calculating these profits, Kleinman relied upon two assumptions. First, Kleinman "normalized" the expenses of the Hyman Agency with regard to

officer's salary, travel and entertainment and advertising and promotion. The normalization of expenses is an accepted industry practice used to determine business valuations, lost profits and damages. Kleinman "normalized" Hyman's salary as manager of the Hyman Agency to $100,000 beginning in 1989 (with $5,000 increases each year thereafter through 1994). Klineman also reduced the Hyman Agency's advertising and promotion expense by 60%, and its travel and entertainment expense by 50%. Kleinman offered no explanation for the former. His basis for the latter was that Internal Revenue Code 274(n) allows only 50% of those expenses.

Kleinman's second assumption was that Hyman should not be credited with NPS losses after 1994. He reasoned that with the loss of the Guardian general agency in 1994, NPS and the Hyman Agency were no longer engaged in a common enterprise, and further, that expenses attributable to post 1994 override commissions has already been incurred. Because the Court accepts certain of the expert's assumptions and reasoning but rejects others, the Court's damages calculation differs from the expert's.

Expert testimony is useful when a case involves issues that require special knowledge or skill not ordinarily possessed by the average person. Such testimony, however, is subject to the same rules concerning reliability as the testimony of any other witness. It is given to assist the trier of fact in reaching a proper conclusion and is entitled to such weight as the expert's qualifications in the field warrant. In this instance, the Court, as the trier of fact, may

reject the expert's opinion if it finds the facts to be different from those which formed the basis for the opinion, or if after careful consideration of all the evidence in the case, it disagrees with the opinion (*Delong v Erie*, 60 NY2d 296).

The court has evaluated the experts testimony in light of these criteria and accepts the expert's opinion regarding the need to normalize Hyman's salary, Although the respondent would discredit Kleinman's opinion as wholly uninformed, he has offered no rebuttal evidence to establish a higher industry standard. To the extent that Hyman is proffering his actual salary of approximately $400,000 per year as a reasonable standard, the court rejects that proposition.

Kleinman's salary estimate bears a more reasonable relation to the profits earned by the Hyman Agency and is approximately equal to the salaries paid by NPS to its key personnel (which according to the testimony ranged from $100,000 to $150,000). The Court does, however, disagree with the expert's salary estimate to the extent it is less than the salaries actually paid to other key employees. Proceeding on the reasonable assumption that Hyman should not be paid less than any one of his employees, the court fixes Hyman's normalized salary at the slightly higher rate of $150,000, including payroll taxes, for each year between 1989 and 1994.

The Court does not accept Kleinman's testimony regarding his normalization of travel, entertainment, advertising and promotion expenses. Aside from his naked assertion that such expenses should be arbitrarily reduced across the board, Kleinman offered no insight as

to the propriety or impropriety of the actual expenses. Nor did Kleinman compare the expenses as a percentage of income against any industry standard or norm. In short, there is no basis in the record to support the expert's arbitrary conclusion.

Instead, the Court accepts petitioner's contention that the business enterprise relationship between, Hyman, the Hyman Agency, NPS and NPA ceased in 1994 and accordingly, the income and expense of Hyman's other ventures, particularly BTI, with respect to its separate and distinct endeavors are not relevant to this inquiry. However, the Court does find that override commissions received by the Hyman Agency and derived from Guardian products sold prior to 1995 are attributable to the common enterprise and must be restored to the corporations.

In addition, the Court does not accept the expert's opinion that NPS and NPA losses for the years 1995 to 2000 should be excluded from the net profit calculation. Kleinman's explanation in this regard was unconvincing, and in any event, such losses are critical to a reasonable determination of the net profit or loss of the enterprise and of the separate corporations from their inception to the present.

Finally, the record supports a finding that not all of Hyman Agency profits were derived from the sale of Guardian products by agents utilizing the services of NPS and NPA. Unfortunately, Hyman Agency financial records do not account for income or expense by profit center and it is impossible to discern or allocate receipts or disbursements by reference to any document or com-

pilation of documents in the record. Moreover, Hyman's own testimony was insufficient to establish a baseline for making such an allocation. Mr. Domino did testify, however, that in his opinion, at least 70-80% of the Hyman Agency's business was generated through the use of NPS. Accordingly, in the absence of more precise documentary evidence, the Court attributes 75% of the income, and normalized expense of the Hyman Agency to its common enterprise with Denton-Hyman, NPS and NPA. This amount, less the operating losses sustained by NPS and NPA from February 15, 1989 to December 31, 2000 shall be returned to Denton-Hyman with simple interest at 9% on the year end balance.[1]

Applying these findings to the facts as developed at trial, the Court calculates the normalized and adjusted profits of NPS, NPA and the Hyman Agency from 1989 through 1994 and of the Hyman Agency from 1995 through 2000 at $2,281,843. The Court also calculates the combined operating losses of NPS and NPA from 1995 through 2000 at $1,077,000 resulting in a net profit from operations through December 31, 2000 of $1,204,843. This amount, plus interest of $1,496,419, for a total of $2,701,262 shall be returned to Denton-Hyman within 30 days of the date of the Decree to be made herein. Additional interest shall accrue on the principal balance at the rate of $297.08 per day.

---

[1] The trial record contains only financial records and testimony regarding the operations of the Hyman Agency, NPS and NPA through 12/31/2000. There is no evidence concerning any years subsequent to year 2000.

Having credited Hyman with 100% of the NPS and NPA losses, it is also necessary to charge Hyman with that portion of the proceeds from the outsourcing of NPS and NPA operations that was used to repay debt incurred prior to December 31, 2001. To do otherwise would, in effect, credit Hyman with recaptured losses. This amount shall also be returned to Denton-Hyman with interest at 9% from April 1, 2002.

In addition, the Court denies Hyman credit for any counsel fees paid by NPS, NPA, Denton-Hyman and the Hyman Agency for any services rendered in the defense of this proceeding. Such sums shall also be returned to Denton-Hyman with simple interest at 9% from the date paid until the date returned. Finally, petitioner is authorized to make application for an allowance of counsel fees for services rendered in the prosecution of this proceeding, which fees shall be paid by Denton-Hyman.

The Court has considered the balance of respondent's arguments and finds them unpersuasive and wholly unsupported by even a sympathetic reading of the testimony and evidence adduced at trial. Accordingly, respondents counterclaim is dismissed and his affirmative defenses are denied in their entirety.

Petitioner's application for the imposition of a constructive trust is denied. Petitioner has failed to identity a fund or asset that can be secured for the benefit of the corporations by the imposition of a constructive trust.

THIS IS THE DECISION OF
THE COURT AFTER TRIAL.

Settle Decree.

Dated: White Plains, New York
December 31, 2002

/s/Anthony Scarpino, Jr.
HON. ANTHONY A. SCARPINO, JR.
Westchester County Surrogate

To: Thacher Proffitt & Wood
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White Plains, New York 10606

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Meyers Tersigni Feldman & Gray LLP
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Of Counsel for Respondents
10 Bank Street - Suite 650
White Plains, New York 10606

At a Surrogate's Court held in and for the County of Westchester, at 140 Grand Street, White Plains, New York 10601, on the 23rd day of April, 2003

PRESENT:

HON. ANTHONY A. SCARPINO, JR.
Surrogate

Application of G. Hallett Denton, as Executor of the Estate of GEORGE W. DENTON,
Deceased,

To Discover Personal Property
Withheld and Belonging to Decedent.

File No.: 719/89

Hon. Anthony A. Scarpino, Jr.

DECREE

Petitioner, G. Hallett Denton, as Executor of the Estate of George W. Denton, Deceased (the "Estate"), residing at 26 White Birch Lane, Mt. Tremper, New York (P.O. Box 1382 Woodstock, New York 12498), having commenced this proceeding against respondents Andrew A. Hyman

("Hyman"), residing at 248 Woodlands Road, Harrison, New York 10528, and the Andrew A. Hyman Agency, Inc. ("Hyman Agency"), a New York corporation located at 123 Main Street, White Plains, New York 10601 of which Hyman is the 100% shareholder, together with respondents, the Denton-Hyman Agency, Inc. ("Denton-Hyman"), National Pension Service, Inc. ("NPS"), and National Pension Actuaries, Inc. ("NPA"), New York corporations located at 123 Main Street, White Plains, New York 10601 of which the Estate and Hyman are 50% shareholders (collectively, the "Corporations"), and petitioner having filed a Second Amended Petition alleging that Hyman had breached his fiduciary duty to the Corporations, and to the Estate, and misappropriated and exploited the assets and goodwill of the Corporations, for the benefit of the Hyman Agency and for his personal benefit, and seeking, *inter alia*, to recover the profits that Hyman and the Hyman Agency obtained through Hyman's breach of fiduciary duty, and their misappropriation and exploitation of such assets; and

Respondents having answered the Second Amended Petition and asserted two counterclaims against petitioner (a) for $100,000 allegedly loaned by Denton-Hyman to the Estate and to two of its beneficiaries; and (b) for override commissions allegedly due Denton-Hyman, but which were allegedly received by the Estate; and

Respondents having moved for summary judgment seeking dismissal of petitioner's claims, and this Court, by decision dated December 20, 2001,

having denied the motion insofar as petitioner asserted claims against Hyman and the Hyman Agency, derivatively, on behalf of Denton-Hyman. NPS and NPA; and respondents having withdrawn their second counterclaim, with prejudice; and

The issues with regard to petitioner's shareholder derivative claims and respondents' first counterclaim having duly come on for trial and having been heard before the Court, without a jury, on April 29 and 30, and May 6, 7, 8, 9, 10, 13 and 15, 2002, and petitioner having appeared by Thacher Proffitt & Wood and Greenfield Stein & Senior, LLP, his attorneys, and respondents having appeared by Meyers Tersigni Feldman & Gray LLP and Donald S. Klein, Esq., their attorneys; and

The Court having heard the allegations and proofs of the parties so appearing and, after due deliberation, having made and filed its decision herein on December 31, 2002, containing a statement of the facts found and of the conclusions of law based thereon, and directing judgment as hereinafter set forth,

Now, on motion of Thacher Proffitt & Wood and Greenfield Stein & Senior, LLP, attorneys for petitioner, it is

ORDERED, ADJUDGED AND DECREED that respondents Hyman and the Hyman Agency shall restore and pay to respondent Denton-Hyman, within thirty (30) days from the entry hereof, and Denton-Hyman shall recover of them, jointly and severally, the amount of $1,204,843, representing the net profits obtained by Hyman and the

Hyman Agency as a result of Hyman's breach of fiduciary duty, as an officer, director and 50% shareholder of Denton-Hyman, NPS and NPA, and their misappropriation of the assets and goodwill of said Corporations, together with interest thereon until December 31, 2002 in the amount of $1,496,419, making altogether the sum of $2,701,262, together with interest on said principal balance of $1,204,843 at the rate of $297.08 per day from January 1, 2003 until April 23, 2003, the date of entry hereof, in the amount of $33,570.04, making altogether the sum of $2,734,832.04; with statutory post-judgment interest to be paid on said sum from the date of entry hereof, and it is further

ORDERED, ADJUDGED AND DECREED that Hyman shall account for, restore and pay to Denton-Hyman, within thirty (30) days from the entry hereof, and Denton-Hyman recover of him, all proceeds from the outsourcing of the business of NPS and NPA which were used to repay debt incurred by NPS and NPA prior to December 31, 2001, including, without limitation, such sums as were repaid to each of Marvin H. Adler, Chief Financial Officer of NPS and NPA, residing at 24 Louis Drive, Melville, New York 11747, and Michael Donahue, then President of NPS, residing at 12068 Broad Meadow Lane, Clarksville, Maryland 21029 and doing business as National Pension Consultants, LLC, located at 2435 Route 6, Brewster, New York 10509, together with simple interest at the rate of 9% from April 1, 2002; and it is further

ORDERED, ADJUDGED AND DECREED that Hyman and The Hyman Agency, shall account for, restore and pay to Denton-Hyman within thirty (30) days from the entry hereof, and Denton-Hyman shall recover of them, the sums of all counsel's fees and disbursements paid by Denton-Hyman, NPS, NPA and the Hyman Agency for any services rendered in the defense of this proceeding, with simple interest of 9% from the date each amount comprising said sums was paid to the date each such amount is restored; and it is further

ORDERED, ADJUDGED AND DECREED that petitioner be and he hereby is authorized to enforce this decree on behalf of Denton-Hyman, MPS and NPA, and to employ all devices provided by the Surrogate's Court Procedure Act and the Civil Practice Law and Rules for such enforcement including, upon compliance with SCPA § 603, execution therefor; and it is further

ORDERED, ADJUDGED AND DECREED that petitioner is authorized to make application for an allowance of counsel fees for services rendered in the prosecution of this proceeding, which counsel's fees shall be paid by Denton-Hyman, the amount thereof to be fixed, at the foot of this decree, such application by petitioner to be on notice to Hyman; and it is further

ORDERED, ADJUDGED AND DECREED that petitioner's application for a constructive trust is denied; and it is further

ORDERED, ADJUDGED AND DECREED that respondents' first counterclaim is dismissed and

their affirmative defenses are denied, with prejudice: and it is further

ORDERED, ADJUDGED AND DECREED that this Court reserves jurisdiction of this proceeding to entertain such applications and to make such further rulings as may be necessary or proper to carry out the provisions of this Court's December 31, 2002 decision and this decree.

/s/Anthony Scarpino, Jr.
Surrogate

SUPREME COURT, APPELLATE DIVISION
SECOND DEPARTMENT, NEW YORK

April 12, 2004

IN THE MATTER OF GEORGE DENTON,
deceased.

G. HALLETT DENTON,
petitioner-respondent,

ANDREW A. HYMAN, *et al.*,
appellants, et al., respondents.

MEYERS TERSIGNI FELDMAN & GRAY, LLP, New York, N.Y. (Anthony L. Tersigni of counsel), *for appellants.*

THACHER PROFFITT & WOOD, White Plains, N.Y. (Kevin J. Plunkett and Greenfield Stein & Senior, LLP [Jeffrey H. Sheetz] of counsel), *for petitioner-respondent.*

In a proceeding pursuant to SCPA 2103 to discover property allegedly withheld from an estate, Andrew A. Hyman, the Andrew A. Hyman Agency, Inc., and Denton-Hyman Agency, Inc., appeal, as limited by their brief, from stated portions of a decree of the Surrogate's Court, Westchester County (Scarpino, S.), dated April 23, 2003, which, after a nonjury trial, inter alia, ordered them to restore and pay net profits obtained as a result of a breach of fiduciary duty and ordered them to restore and pay proceeds from the outsourcing of the business of National Pension Service, Inc., and National Pension Actuaries, Inc.

ORDERED that the decree is affirmed insofar as appealed from, with costs payable by the appellants, and the petitioner's second amended petition is deemed amended to include a claim for proceeds from the outsourcing of the business of National Pension Service, Inc., and National Pension Actuaries, Inc., which was used to repay debt incurred by them prior to December 31, 2001.

The appellants challenge the jurisdiction of the Surrogate's Court over this proceeding. "[F]or the Surrogate's Court to decline jurisdiction, it should be abundantly clear that the matter in controversy in no way affects the affairs of a decedent or the administration of his estate"(*Matter of Piccione*, 57 N.Y.2d 278, 288, 456 N.Y.S.2d 669, 442 N.E.2d 1180; *Matter of Young*, 80 Misc.2d 937, 939, 365 N.Y.S.2d 695). Since the focus of the litigation is the valuation of the subject business entities and whether the estate is entitled to any part thereof, the Surrogate's Court has jurisdiction over the dispute (*see Ruiz v. Ruiz*, 262 A.D.2d 392, 690

N.Y.S.2d 749; *H & G Operating Corp. v. Linden*, 151 A.D.2d 898, 542 N.Y.S.2d 868).

A determination rendered after a nonjury trial should not be disturbed on appeal unless it is clear that the court's conclusion could not have been reached under any fair interpretation of the evidence *(see Belloff v. Wayco Agencies*, 280 A.D.2d 503, 720 N.Y.S.2d 377; *Alleva v. Alleva Dairy*, 129 A.D.2d 663, 514 N.Y.S.2d 422). Here, the evidence presented at trial established that the appellant Andrew A. Hyman breached his fiduciary duty to the Denton-Hyman Agency, Inc., National Pension Service, Inc., and National Pension Actuaries, Inc. Accordingly, we discern no basis in the record to disturb the Surrogate's Court's credibility determination.

Although the petitioner did not include in his second amended petition a claim for proceeds from the outsourcing of the business of National Pension Service, Inc., and National Pension Actuaries, Inc., which was used to repay debt incurred by them prior to December 31, 2001, the issue was litigated in the Surrogate's Court. Pursuant to CPLR 3025(c), pleadings may be conformed to the proof at any time upon such terms as may be just *(see Thailer v. LaRocca*, 174 A.D.2d 731, 571 N.Y.S.2d 569). This court may, sua sponte, relieve a petitioner of the failure to amend a pleading by deeming it amended to conform to the evidence presented at trial where, as here, it would not result in prejudice to the opposing party *(see Cave v. Kollar*, 2 A.D.3d 386, 767 N.Y.S.2d 856; *Thailer v. LaRocca, supra)*. Accordingly, the second amended petition is deemed amended to include the claim for proceeds from the outsourcing of the

business of National Pension Service, Inc., and National Pension Actuaries, Inc., which was used to repay debt incurred by them prior to December 31, 2001.

The appellants' remaining contentions are without merit.

SMITH, J.P., GOLDSTEIN, MASTRO and RIVERA, JJ., concur.

STATE OF NEW YORK
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the twenty-ninth day of June 2004

Present,
HON. JUDITH S. KAYE, *Chief Judge, presiding.*

Mo . No. 612 SSD 41

IN THE MATTER OF GEORGE DENTON, Deceased.

G. HALLETT DENTON,

Respondent,

—v.—

ANDREW A. HYMAN, *et al.*,

Appellants.

The appellants having filed notice of appeal in the above title and due consideration having been thereupon had, it is

ORDERED, that the appeal be and the same hereby is dismissed without costs, by the Court *sua sponte*, upon the ground that the order

appealed from does not finally determine the proceeding within the meaning of the Constitution.

/s/ Stuart M. Cohen
Stuart M. Cohen
Clerk of the Court

STATE OF NEW YORK
COURT OF APPEALS

At a session of the Court, held at Court of Appeals Hall in the City of Albany on the twenty-seventh day of October 2005

Present,
HON. JUDITH S. KAYE, *Chief Judge, presiding.*

2-10 Mo. No. 867

IN THE MATTER OF GEORGE DENTON, Deceased.

G. HALLETT DENTON,

Respondent,

—v.—

ANDREW A. HYMAN, *et al.*,

Appellants,

et al.,

Respondents.

A motion for leave to appeal to the Court of Appeals in the above cause having heretofore been made upon the part of the appellants herein and papers having been submitted thereon and due deliberation having been thereupon had, it is

ORDERED, that the said motion be and the same hereby is denied.

/s/ Stuart M. Cohen
Stuart M. Cohen
Clerk of the Court

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

Chapter 7
Case No. 03 B 22150 (ASH)

In re

ANDREW A. HYMAN,

Debtor.

G. HALLETT DENTON, as Executor of the Estate of George W. Denton,

Plaintiff,

—against—

ANDREW A. HYMAN,

Defendant.

Adv. Pro. No. 04-08536

STATE OF NEW YORK)
) ss:
COUNTY OF NEW YORK)

ANDREW A. HYMAN, being duly sworn, deposes and says:

1. I am the debtor in this bankruptcy case . . . .

* * *

25. As noted, ... plaintiff never objected to the use of Denton-Hyman overrides to fund NPS and to pay off the more than $1.6 million debt, as to which the George Denton's estate and I were jointly and severally liable. At trial, plaintiff acknowledged that: (i) he was aware of, and did not object to, the use of the Denton-Hyman overrides to pay said debt; (ii) the use of the overrides for this purpose was proper and benefited all concerned, including Denton-Hyman and NPS; and (iii) the estate's exposure for the substantial debt guaranteed by his father and me was "certainly" a concern of his (Exh. 6, pp. 19-34).

* * *

30. In short, ... prior to the commencement of the Surrogate's Court proceeding, we were able to collect more than $1,350,000 of override commissions payable to Denton-Hyman, as well as approximately $170,000 of personal commissions which were paid directly to the Denton estate by Guardian. Because of the structure of the override commissions, the amounts collected in these first five years represented almost 85% of the

total amount collected through May 1998 (*i.e.*, more than $1,600,000). Moreover, as a result of these collections, by the end of 1993, I was able to retire the entire debt of The Bank of New York, the entire Guardian debt and over $400,000 of the principal amount of the Deppe debt (the balance of the Deppe debt was paid off in its entirety in the fall of 1997).

SURROGATE'S COURT OF THE
STATE OF NEW YORK
COUNTY OF WESTCHESTER

File No. 719/89

In the Matter of the Estate of

GEORGE DENTON,

Deceased.

---

140 Grand Street
White Plains, New York 10601

April 29, 2002

TRANSCRIPT OF TRIAL

B E F O R E:

HON. ANTHONY A. SCARPINO, JR.,
Surrogate, Westchester County

TRANSCRIBER:

COMPU-SCRIBE, INC.
BY: CATHERINE ALDRICH

* * *

[25] [MR. TERSIGNI (Debtor's Counsel):]

. . . as the evidence will show, it was a proper good-faith business judgment of Mr. Hyman to continue to operate NPS because not to do so for reasons which will be explained during the course of the trial, would have been highly detrimental to the Denton Hyman Agency and its expectancy of collecting future override commissions following [26] the death of George Denton, and it was those future override commissions which were in fact preserved and maximized by Mr. Hyman that were used to pay all of the corporate debt on which these corporations were liable, and on which the estate and Mr. Hyman personally were also liable . . . .

SURROGATE'S COURT
COUNTY OF WESTCHESTER

File No. 719/89

APPLICATION OF G. HALLETT DENTON, as Executor of the Estate of

GEORGE DENTON,

Deceased,

To Discover Personal Property Withheld And Belonging to Decedent.

TRIAL MEMORANDUM ON BEHALF OF RESPONDENTS

* * *

The Deppe debt remained unpaid. Additional debt existed to The Guardian for general agency advances on which both the estate and Hyman were jointly and severally liable. Still more debt to the Bank of New York was outstanding which had been obtained by decedent and Hyman for Denton-Hyman. The aggregate amount of these outstanding debts exceeded $1.6 million. While

these large amounts of unpaid debt were problematic for Hyman, they were even more problematic for the estate, since Hyman had only modest assets whereas decedent's estate had assets of several million dollars and could not avoid collection through bankruptcy.

Following decedent's death . . . Hyman made the good-faith business judgment, with petitioner's knowledge and acquiescence, to continue to operate NPS. His primary reason for doing so was to preserve and maximize Denton-Hyman's override commissions on pension business written prior to decedent's death, in order to pay off the substantial outstanding debt.

* * *

The overrides of Denton-Hyman were thereby preserved and greatly maximized . . . . As a result, all of the previously discussed debt outstanding at decedent's death—as to which, as noted, the estate and Hyman were jointly and severally liable—was paid.

* * *

The evidence will show that . . . . The override commissions, as noted, were preserved and max imized and, along with the other funds of Denton-Hyman, properly used to pay corporate debt and continue the operations of NPS.

OPPOSITION BRIEF

88

(2)

No. 07-952

FILED
MAR 21 2008
OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE

Supreme Court of the United States

G. HALLETT DENTON, as Executor of the Estate of GEORGE W. DENTON,

Petitioner,

v.

ANDREW A. HYMAN,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Petitioner has presented compelling reasons to grant the Petition, where the decision below relied, and is fully defensible, on an independent state law ground – in this case, the New York law of collateral estoppel.

2. Whether Petitioner has presented compelling reasons to grant the Petition, where, apart from the independent state law ground of collateral estoppel, this case can be decided on other alternative grounds without reaching the alleged conflict in Circuit Court decisions relied on by Petitioner.

3. Whether Petitioner has presented compelling reasons to grant the Petition, where the alleged conflict in Circuit Court decisions relied on by Petitioner does not implicate the facts of this case, and where, contrary to Petitioner's argument, no Circuit has adopted a blanket rule that no degree of wrongdoing is ever required to establish the defalcation exception under Bankruptcy Code § 523(a)(4).

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III. Certiorari is not warranted where, as here, the alleged conflict in Circuit Court decisions does not implicate the facts of the case. 11

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STATEMENT OF THE CASE

A detailed statement of the facts is set forth in the "Background" section of the opinion of the Second Circuit (3a-8a)[1], which is incorporated by reference here. Briefly:

The underlying adversary proceeding in this case arose out of a decision of the Surrogate's Court, Westchester County, New York, dated December 31, 2002 (the proceeding in the Surrogate's Court having been commenced in 1994), in which the Surrogate awarded a judgment of $2,734,832.04 against Respondent, Andrew A Hyman ("Respondent" or "Hyman") and the Andrew A. Hyman Agency, Inc. in favor of the Denton-Hyman Agency, Inc., a company owned 50% each by Hyman and the estate of the decedent, George Denton. Petitioner, G. Hallett Denton ("Petitioner" or "Denton"), is the son of George Denton and the executor of his estate.

Following the Surrogate's Court decision, Hyman filed for bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York. Petitioner commenced an adversary proceeding seeking an order declaring the Surrogate's Court judgment non-dischargeable under various sections of the Bankruptcy Code, including § 523(a)(4), alleging defalcation while acting in a fiduciary capacity.

Petitioner moved for summary judgment on the ground that Respondent's alleged defalcation was established, as a matter of law, by application of the New

1. This and similar references are to the Appendix to the Petition.

York doctrine of collateral estoppel. Respondent cross-moved for summary judgment. In a preliminary opinion issued on the record from the bench, the Bankruptcy Court (Judge Adlai S. Hardin, Jr.) denied both motions for summary judgment, concluding that both sides should have the opportunity "to present evidence at a trial necessary to establish, and defend against, plaintiff's claim of non-dischargeability under Section 524(a)(4)" (42a). Despite originally indicating to the Bankruptcy Court that he would proceed to trial, on the eve of trial, Petitioner made the tactical decision to seek a voluntary dismissal, with prejudice, of his fourth cause of action under Section 523(a)(4). Accordingly, Petitioner affirmatively waived a trial and decided, instead of proceeding to trial, to rely solely on the New York doctrine of collateral estoppel (42a-43a).

Petitioner having waived a trial, the Bankruptcy Court issued a final written decision addressing Petitioner's collateral estoppel argument. In rejecting that argument, Judge Hardin, held, *inter alia*, that the issues in the adversary proceeding were not the same issues decided by the Surrogate's Court. In so holding, Judge Hardin stated:

> This conclusion is underscored when one attempts to understand what it was that Hyman did or did not do after Denton's death that could fairly be characterized as a defalcation or as intentionally wrongful, illicit or reprehensible, such as to justify denial of Hyman's discharge. *There is no finding of fact by the Surrogate, and no claim by the plaintiff in this adversary proceeding, that Hyman*

took money or property of Denton-Hyman Agency, NPS or NPA without accounting for it – i.e. no claim of defalcation in the ordinary dictionary sense of that word (original italics) (68a).

*****

During oral argument on the summary judgment motions, this Court repeatedly asked the attorneys for plaintiff, including the Executor's counsel in the Surrogate's Court proceeding, to specify precisely what it was that Hyman did that was illicit, morally reprehensible or otherwise wrongful, other than the fact that he ultimately did not reach agreement with the Executor as to the amount to be paid in a buy-out of the Denton Estate's 50% interest in Denton Hyman. . . . Despite repeated opportunities to answer these questions, plaintiff's counsel never identified any specific conduct on the part of Hyman which could be characterized as a defalcation, or any conduct of any kind that was wrongful, illegal or morally reprehensible, other than the fact that the parties ultimately did not reach agreement on a buy-out. Nor did the Surrogate in his Decision (71a-72a).

Petitioner appealed the decision of the Bankruptcy Court to the District Court. The sole issue on appeal was whether the Bankruptcy Court properly determined that, applying the New York law of collateral estoppel, the alleged findings and conclusions of the Surrogate

were not sufficient to establish that Hyman had engaged in defalcation within the meaning of Section 523(a)(4).[2]

---

2. In its Petition to this Court (pp. 4-5), Petitioner misleadingly argues that (i) the Surrogate rejected Hyman's contention that he was acting in good faith by operating NPS (one of the companies in issue) to preserve and maximize commissions and (ii) the Surrogate found that Denton had not consented and acquiesced in Hyman's actions. In fact, neither of these findings was made by the Surrogate.

As to first, the Surrogate did not address the issue of Hyman's good faith, holding only that the proof did not support a finding that the continued operation of NPS was "essential" to protect and maximize commissions (91a). Such a holding did not detract from Hyman's good faith belief that it was "helpful" for that purpose – a belief shared by several witnesses at trial, including one of Denton's own witnesses.

As to the second, Judge Conner noted that in proffering the argument that the Surrogate made such a finding, Denton relied on a single sentence in the conclusion section of the Surrogate's decision: "The Court has considered the balance of the respondent's arguments and finds them unpersuasive and wholly unsupported by even a sympathetic reading of the evidence adduced at trial." In that regard, Judge Conner stated:

> The Bankruptcy Court questioned the extent to which this language permitted collateral estoppel on an issue decided at best implicitly. As do we. . . . [W]e cannot say that the Bankruptcy Court's determination regarding [Denton's] 'knowledge and acquiescence' of Debtor's actions was clearly erroneous given the overwhelming evidence in the record indicating [Denton's] acknowledgement of and willingness to allow the continuation of the business.

(35a). In this same vein Judge Hardin had observed during oral argument, that not only was such a finding absent from the Surrogate's Court's decision, it would be "confounded by the testimony of the executor."

The District Court (Senior Judge William Conner) affirmed the Bankruptcy Court's decision.

Petitioner appealed from the District Court's judgment to the Second Circuit – again on the sole issue of collateral estoppel. In affirming the judgment below, the Second Circuit noted that this case presented "unique circumstances" and, relying on principles of New York law governing application of the doctrine of collateral estoppel, stated:

> In view of these complexities, we are loath to conclude that an identical issue was necessarily decided or that Hyman had a full and fair opportunity to contest his state of mind. In addition to the murkiness of the law, the harsh consequences that follow a finding of nondischargeability and the requirement that the exceptions be narrowly construed both counsel against precluding a plenary trial in Bankruptcy Court, had the [Denton] estate not voluntarily agreed to forego one here. Accordingly, we conclude that collateral estoppel does not attach.

Following the Second Circuit decision, Petitioner moved for panel rehearing and rehearing *en banc*. His motions were denied, the Second Circuit noting that not one judge had requested that a vote be taken on the *en banc* request (82a).

This Petition followed.

REASONS FOR DENYING THE PETITION

I. The decision below relied, and is fully defensible, on an independent state law ground.

The sole issue raised by Petitioner below was whether or not the decision of the Surrogate, in and of itself, under the New York law of collateral estoppel, was sufficient to establish that Respondent engaged in defalcation while acting in a fiduciary capacity within the meaning of the Bankruptcy Code. Thus, this case turns on the interpretation of state law.

This was expressly recognized by the Second Circuit at the outset of its legal discussion, where, citing a decision of this Court, it stated: "To determine whether collateral estoppel applies to the Surrogate's Court's judgment, we look to New York law" (8a).

As a review of the Second Circuit's decision confirms, its discussion of the issue of defalcation, and various Circuit Court decisions relating to that issue, was undertaken to address, as New York law requires, "whether a 'defalcation while acting in a fiduciary capacity' under § 523(a)(4) of the Bankruptcy Code was identical to the factual and legal determinations necessarily decided in the prior Surrogate's Court action" (9a-10a).[3]

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3. As noted by the Second Circuit, under New York law, collateral estoppel bars relitigation of an issue if, among other requirements, the *identical issue* necessarily was decided in the prior action (8a-9a).

As noted, in concluding that collateral estoppel did not apply, the Second Circuit pointed to the following considerations: (i) the "murkiness" of the law regarding defalcation, (ii) the harsh consequences that follow a finding of nondischargeability, (iii) that the exceptions to discharge must be narrowly construed and (iv) that Petitioner had voluntarily agreed to forego a plenary trial (18a). Taking these considerations into account, in determining that collateral estoppel did not attach, the Second Circuit applied principles of New York law – including, that "collateral estoppel is a flexible doctrine and whether to apply it in a particular case depends on 'general notions of fairness involving a practical inquiry into the realities of the litigation'" (9a).

Under these circumstances, any clarification by this Court, at this late juncture, with respect to the meaning of defalcation, would, it is respectfully submitted, in no way change the result under New York law concerning the applicability of collateral estoppel. It is the murkiness of the law at the time that collateral estoppel was invoked by Petitioner that would be one of the relevant factors to be considered under New York law.[4]

In short, since the decision of the Second Circuit essentially turned on New York law, for this reason alone, Petitioner has failed to present any compelling ground to grant *certiorari*.

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4. Indeed, the fact that Petitioner chose voluntarily to waive a plenary trial precluded the development of a full record on which this Court might have reviewed the issue sought to be presented, if it were otherwise appropriate to do so.

II. The existence of further alternative grounds for affirming the decision below negates any compelling reason to grant certiorari.

No compelling reason to grant the Petition is presented where, as here, there exist a number of alternative grounds, separate and apart from the New York law of collateral estoppel, for affirming the decision of the Second Circuit, without the need to reach the alleged conflict in Circuit Court decisions relied on by Petitioner. *See, e.g., The Monrosa v. Carbon Black Export, Inc.*, 359 U.S. 180, 184 (1959):

> While this Court decides questions of public importance, it decides them in the context of meaningful litigation. Its function in resolving conflicts among the Courts of Appeals is judicial, not simply administrative or managerial. Resolution here of the *** [issue in conflict among the circuits] can await a day when the issue is posed less abstractly.[5]

Among the alternative grounds for affirmance presented by the record (which the Second Circuit did not find it necessary to address) are the following:

(a) Hyman was not a fiduciary for section 523(a)(4) purposes. It has been recognized repeatedly that "fiduciary capacity contemplated under Section 523(a)(4) applies only to technical or express trusts and not to

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5. The exceedingly abstract context in which Petitioner seeks review by this Court is underscored, once again, by the fact that Petitioner waived a plenary trial through which a full record could have been developed and presented to this Court.

trusts *ex maleficio.*" *See, e.g., Sandak* v. *Dobrayel (In re Dobrayel)*, 287 B.R. 3, 14 (Bankr. S.D.N.Y. 2002); *Adamo* v. *Scheller (In re Scheller)*, 265 B.R. 39, 52 (Bankr. S.D.N.Y. 2001).

Under New York law, corporate officers and directors are not treated as trustees of their company's assets, except for the benefit of creditors *if their corporation becomes insolvent. Clarkson Co. Ltd.* v. *Shaheen*, 660 F.2d 506 (2d Cir. 1981). Otherwise, the fiduciary obligations of corporate officers and directors, as codified in the New York Business Corporation Law, are based on the common law of agency. *See Pereira* v. *Centel Corp. (In re Argo Communications Corp.)*, 134 B.R. 776, 789 (Bankr. S.D.N.Y. 1991) ("Fiduciaries such as officers and directors are essentially agents of the corporation").

Since under New York law Hyman was not a trustee of the corporate assets,[6] his common law and statutory fiduciary obligations as a corporate *agent* are not sufficient to give rise to an express or technical trust as required under section 523(a)(4). *See Cal-Micro, Inc.* v. *Cantrell (In re Cantrell)*, 329 F.3d 1119 (9th Cir. 2003), in which the Ninth Circuit analyzed a California corporation statute analogous to New York's and

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6. This is confirmed by the very decision of the Surrogate's Court on which Petitioner relied. In that proceeding, Petitioner asserted a claim for the imposition of a constructive trust based on Hyman's alleged breach of fiduciary duty. However, in the Surrogate's decision, this claim was dismissed on the ground that "[p]etitioner has failed to identify a fund or asset that can be secured for the benefit of the corporations by the imposition of a constructive trust" (98a).

concluded that "[b]ecause under California law a corporate officer is not a fiduciary within the meaning of § 523(a)(4), . . . Cantrell [the debtor] is entitled to summary judgment [dismissing] Cal-Micro's non-dischargeability claims." *Id.* at 1128. The same conclusion is warranted in this case.

(b) Even if it were to be assumed, *arguendo*, that Hyman was a fiduciary for purposes of section 523(a)(4), he was not "acting in a fiduciary capacity" within the meaning of the Bankruptcy Code with respect to the matters in issue. *See Zohlman* v. *Zoldan (In re Zoldan)*, 221 B.R. 79, 87 (Bankr. S.D.N.Y. 1998), *aff'd*, 226 B.R. 767 (S.D.N.Y. 1998): "The mere *existence* of a fiduciary relationship is not sufficient to deny dischargeability under Section 523(a)(4). The Court must also make a finding that the debtor-defendant was '*acting* in a fiduciary capacity' with respect to the particular conduct giving rise to the liability which is claimed to be non-dischargeable" (emphasis in original).

The underlying conduct relating to this point, and the relevant legal authorities, are discussed in Judge Hardin's opinion (76a-79a).

(c) Petitioner's voluntary dismissal *with prejudice* of the fourth claim for relief contained in the petition in the Surrogate's Court, constituted a final determination on the merits in Hyman's favor with respect the issue of non-dischargeability under section 523(a)(4). As such, the dismissal was *res judicata* and constituted a bar to Petitioner's seeking a judgment on the identical claim under any theory, including collateral estoppel under New York law, the theory set forth in Petitioner's first

claim for relief. *See Beard v. Sheet Metal Workers Union, Local 150*, 908 F.2d 474, 477 n.3 (9th Cir. 1990); *Matter of Energy Cooperative, Inc.*, 814 F.2d 1226, 1230-31 (7th Cir. 1987).

Petitioner's appeal is based solely on his first claim for relief, which did nothing more than assert collateral estoppel as a *legal theory of liability* supporting non-dischargeability under section 523(a)(4). The underlying facts – the basis for the fourth claim for relief – are what constituted Petitioner's claim, not the legal theory of collateral estoppel. Therefore, when Petitioner voluntarily relinquished his fourth claim by consenting to an adverse determination on the merits, with prejudice, he gave up any substantive claim he had under section 523(a)(4). *See Sure-Snap Corp. v. State Street Bank and Trust Co.*, 948 F.2d 869, 874 (2d Cir. 1991); *Expert Electric, Inc. v. Levine*, 554 F.2d 1227, 1234 (2d Cir. 1977).

III. Certiorari is not warranted where, as here, the alleged conflict in Circuit Court decisions does not implicate the facts of the case.

Petitioner contends that three Circuit Court cases, *In re Uwimana*, *In re Cochrane* and *In re Hemmeter* (in the Fourth, Eighth and Ninth Circuits, respectively) conflict with the decision of the Second Circuit in this case (and with decisions of First, Fifth, Sixth, Seventh, Tenth and Eleventh Circuits, all of which require some element of wrongdoing to find defalcation) (Petition, pp. 8-11).[7] However, the alleged conflict relied on by

7. It appears that the Third Circuit has not addressed this issue.

Petitioner does not implicate the facts of this case in that each of the cases relied on by Petitioner involved a technical or express trust – *i.e.*, the misappropriation or failure to account for trust funds. In the present case, unlike those cases, Hyman was held liable for breaching his fiduciary duty as a corporate officer and director, not by taking trust funds, but by allegedly using assets to obtain profits for himself.

As Judge Hardin held: "*There is no finding of fact by the Surrogate, and no claim by the plaintiff in this adversary proceeding, that Hyman took money or property of Denton-Hyman Agency, NPS or NPA without accounting for it. . . .*" (original emphasis). Similarly, the Surrogate held: "Hyman and the Hyman Agency are accountable and liable for the net profits realized in breach of their fiduciary duty . . ." (93a).[8]

While there may be differences in the majority of the Circuits as to the *degree* of wrongdoing required to establish defalcation under Section 523(a)(4), clarification of that issue would not impact the outcome of this case, and would, in effect, constitute an advisory opinion, since it is Petitioner's position is that *no* degree of wrongdoing or bad faith is ever required – a position that no Circuit has adopted. Indeed, such a holding would be wholly inconsistent with this Court's observation that the basic policy animating the Bankruptcy Code is to afford the "honest but unfortunate" debtor a fresh start. *Marrama v. Citizens Bank of Mass.* (127 S. Ct. 1105, 1107 (2007); *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991).

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8. As previously noted, the Surrogate denied Denton's application for a constructive trust because Denton had failed to identify a fund or asset upon which a constructive trust could be applied.

IV. Apart from the reasons discussed, the Petition should be denied for various additional reasons.

(a) Petitioner's argument (Petition, pp. 14-18) that the Second Circuit's decision undermines common law remedies against self-dealing corporate offices and directors is baseless. Petitioner's argument is summarized in his assertion that "[i]n New York, at least, corporate fiduciary judgment debtors now need only repair to the Bankruptcy Court to obtain complete exoneration" (*Id.* at 17).

Apart from the fact that state court judgments could, unlike in the present case, be based on findings that might support the application of collateral estoppel, it was Petitioner in this case who made the tactical decision to waive a trial on the issue of defalcation (perhaps recognizing the weakness of his position), relying instead on the application of collateral estoppel to the wholly inadequate findings of fact made by the Surrogate below. The decision of the Second Circuit in no way would have prevented Petitioner from seeking to establish, at a plenary trial, facts that might have supported his argument that the judgment against Hyman was non-dischargeable under Section 523(a)(4). Petitioner voluntarily chose not to avail himself of that opportunity.

(b) Petitioner's argument that the Second Circuit's decision below is inconsistent with its own decisions in *In re Hammond* and *Central Hanover Bank & Trust Co. v. Herbst* (Petition, pp. 11-13) is similarly baseless. Petitioner made the same argument below, and the Second Circuit addressed the argument and concluded that its present decision was not inconsistent with either

of those earlier decisions (11a-13a). In any event, even if there were an inconsistency among the various decisions of the Second Circuit, such inconsistencies are generally not the basis for granting *certiorari*. Instead, they are ordinarily settled through *en banc* review. Here, as noted, not one judge requested that a vote be taken on Petitioner's application for *en banc* review (82a).

(c) Finally, this case was correctly decided by the Bankruptcy Court, the District Court and the Second Circuit, all taking into account (i) the good faith conduct of Respondent, (ii) the philosophical and practical centerpiece of the Bankruptcy Code affording the "honest but unfortunate" debtor a "fresh start," (iii) the corollary principle that exceptions to discharge must be narrowly construed and (iv) the proper application of the flexible doctrine of collateral estoppel, under New York law, in a manner which comports with "general notions of fairness involving a practical inquiry into the realities of the litigation."

CONCLUSION

For the reasons stated, Petitioner has not established any compelling reason for this Court to grant *certiorari*. Therefore, Respondent respectfully requests that the Petition be denied.

Respectfully submitted,

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SUPPLEMENTAL BRIEF

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No. 07-952

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IN THE

Supreme Court of the United States

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON,

Petitioner,

—v.—

ANDREW A. HYMAN,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

SUPPLEMENTAL BRIEF FOR PETITIONER

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STATEMENT

This Supplemental Brief is submitted in response to the Solicitor General's recommendation that certiorari be denied, notwithstanding his concurrence that (a) the Second Circuit **"Erred in Categorically Holding That Proof Of Deliberate Misbehavior Or Extreme Recklessness Is Required To Establish A 'Defalcation' Within The Meaning of 11 U.S.C. 523(a)(4)"** (Solicitor General's Brief, hereinafter "SGB", p. 7) (emphasis in original), and (b) his recognition that the circuit courts are now divided into "'three interpretive camps'" (*Id.*, p. 16)[1] regarding the level of wrongdoing, i.e., "scienter", required to render non-dischargeable a debt resulting from a "defalcation while acting in a fiduciary capacity" under the Bankruptcy Code.

The Solicitor General's recommendation, we submit, is based on misconceptions of the underlying state court litigation, a failure to distinguish between the applicability of collateral estoppel to factual as opposed to legal issues, and the same critical deficiency which has contributed to the ongoing morass of irreconcilable circuit court decisions, i.e., the failure to distinguish fiduciary self-dealing from all other fiduciary failings. The latter are characterized by detriment to the cestui without gain to the fiduciary; these do not necessarily constitute defalcations for § 523(a)(4) purposes. With respect to the self-dealing fiduciary, the law has favored an absolute bar, regardless of subjective considerations.

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[1] More accurately described by the Second Circuit as "persistent confusion." (15a); Numbers followed by "a" refer to the indicated page of the Appendix annexed to the Petition.

As recognized by the Solicitor General:

> At least in circumstances where the relevant breach of duty is a wrongful diversion of trust assets to the fiduciary's own use . . . the breach is properly regarded as a "defalcation" within the meaning of Section 523(a)(4), regardless of whether the fiduciary acts with ill intent.

(SGB, p. 6)

In these latter circumstances, a core value is at stake, i.e., that one cannot serve two masters; when self is juxtaposed to duty, duty must prevail. Whether the result of accident, design or otherwise—and because we can never know which—the self-dealing fiduciary's enrichment to the detriment of his cestui is always a "defalcation." Properly interpreted, § 523(a)(4) reflects that core value.

THE STATE COURT LITIGATION

The underlying state court litigation presented garden variety corporate fiduciary self-dealing issues for adjudication. As summarized in the trial court's decision, the petitioner [Denton Estate] "as a 50% shareholder of three corporations" sought to "recover . . . (i) profits earned by [respondent; the surviving 50% shareholder, officer and director] and the Hyman Agency [his 100% owned corporation] in exploiting the assets of [the jointly-owned] corporations; [and] (ii) damages suffered as a result of the diversion of corporate assets . . . ."; respondent "asserted a number of defenses, including statute of limitations, ratification and estoppel." (84a-85a)

After a nine-day trial, the trial court found that:

(a) the decedent and respondent were 50% shareholders of a three corporation enterprise (85a);

(b) respondent, as "a 50% shareholder, officer and director . . . owed a fiduciary duty to those corporations" (92a);

(c) immediately following the decedent's death, respondent "breached that duty by co-opting the . . . enterprise for the benefit of [his newly-formed, 100% owned] . . . Hyman Agency and for his own personal enrichment" (92a);[2]

(d) "Hyman [respondent] exploited the assets of NPS and NPA [two of the jointly-owned corporations] to obtain profits for himself" (90a); and

(e) "[h]is actions constituted a misappropriation of the tangible assets and goodwill of [the jointly-owned corporations]." (92a-93a)

The trial court rejected respondent's counterclaim and affirmative defenses and "dismissed [them] . . . in their entirety." (98a)

These findings were unanimously affirmed on appeal and further appeals were twice rejected by New York's Court of Appeals. (106a-113a)

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[2] The Solicitor General recognized that the respondent continued "to operate the overall enterprise in a way that predictably resulted in profits for the Hyman Agency and losses for NPS" (SGB, p. 19-20), but failed to comprehend that the losses borne by the 50% owned entity were now being incurred for the benefit of the respondent's newly-formed 100% owned entity. In other words, the losses were left to be shared 50/50, but 100% of the profits diverted to respondent.

Self-dealing by a corporate fiduciary is hardly "idiosyncratic" (SGB, p. 19), except, perhaps, in the details. In view of the trial court's explicit findings regarding the respondent's fiduciary status, his "co-opting" of the parties' jointly-owned corporate enterprise "for his own personal enrichment" (92a), his "exploit[ation]" of that enterprise "to obtain profits for himself" (90a), and his "misappropriation of the tangible assets and goodwill" of that enterprise (92a-93a), it would appear difficult to contend that "no finding was made that respondent divested those corporations of their property." (SGB, p. 19)

The Solicitor General's suggestion that this case "does not provide an attractive vehicle" (SGB, p. 21) to resolve an issue which "is important to the administration of the bankruptcy laws" (*Id.*, p. 18), an issue which has "arisen frequently" and has divided the courts of appeals (*Id.*, pp. 17-18) is based, *inter alia*, on the erroneous view that these factual findings are not binding because the trial court (a) was not presented with the "question . . . whether respondent had committed a Section 523(a)(4) 'defalcation,' but whether he had committed a state-law breach of fiduciary duty," and (b) " 'made no express findings with respect to [respondent's] state of mind' " (quoting from the Second Circuit's decision). (16a)[3] (SGB, p. 18)

It is self-evident that bankruptcy law issues regarding dischargeability are never presented to

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[3] The Second Circuit, having concluded that a "defalcation" under Section 523(a)(4) requires "culpable" conduct, declined to accord the trial court's findings preclusive effect based on the theory that since good faith or innocent motives are not defenses to a corporate fiduciary self-dealing claim, the state court was not required to, and thus did not necessarily find that respondent acted with culpable intent. (16a-18a).

state courts, certainly not prior to the adjudication resulting in the debt subsequently sought to be discharged. The test for the application of collateral estoppel, is not whether the legal issue of "defalcation" was determined by the trial court, but whether the facts necessarily determined by that court constitute a "defalcation" under § 523(a)(4). Indeed, were the Solicitor General's contentions to be adopted, collateral estoppel could never be applied in fiduciary self-dealing cases, since "state of mind" is not an issue under state law, rendering any such finding unnecessary, and therefore not a basis for collateral estoppel, which only accords preclusive effect to necessary findings. "Taking [the Solicitor General's] argument to its logical conclusion, collateral estoppel would never apply in bankruptcy because the precise bankruptcy issue would never have been litigated in a court action prior to the filing of the petition in bankruptcy. Such a conclusion defies common sense and reason and is at odds with the Supreme Court's holding in *Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654 (1991)." *In re Docteroff*, 133 F.3d 210, 215 (3d Cir. 1997).

Here, under the Solicitor General's own analysis of the law, the facts found by the trial court—that respondent "co-opt[ed]" the parties' jointly-owned corporate enterprise "for his own personal enrichment" (92a), that he "exploited" that enterprise "to obtain profits for himself" (90a), and that he "misappropriat[ed] [its] tangible assets and goodwill" demonstrate a "defalcation"—i.e., unquestionably constitute a "wrongful diversion of trust assets to the fiduciary's own use" (SGB p. 6), and is the one category of fiduciary misconduct which is clearly a "defalcation" under § 523(a)(4), regardless of the

fiduciary's protestations of good faith or intentions. (SGB, p. 14)

These determinations are binding on the parties in all subsequent litigation involving the same factual issues and the courts in which those issues are litigated. *Kremer v. Chemical Construction Corp.*, 456 U.S. 461, 102 S. Ct. 1883 (1982). The Full Faith and Credit clause of the U.S. Constitution, Article IV, § 1, as implemented by 28 U.S.C. § 1738, "requires federal courts to give the same preclusive effect to State court judgments that those judgments would be given in the courts of the state from which the judgments emerged." 456 U.S. at 466, 102 S.Ct. at 1889; *accord Parsons Steel, Inc.* v. *First Alabama Bank*, 474 U.S. 518, 523, 106 S. Ct. 768, 771 (1986). That "statute has long been understood to encompass the doctrines of res judicata, or 'claim preclusion,' and collateral estoppel, or 'issue preclusion.'" *San Remo Hotel, L.P. v. City and County of San Francisco*, 545 U.S. 323, 336, 125 S. Ct. 2491, 2500 (2005), citing *Allen v. McCurry*, 449 U.S. 90, 94-96, 101 S. Ct. 411 (1980). Without question, under New York law, New York courts would be bound by the trial court's factual findings in any subsequent litigation between the same parties involving the same facts, regardless of the legal issues then in contention. *Hinchey v. Sellers*, 7 N.Y.2d 287, 197 N.Y.S.2d 129 (1959) ("It is of course well-settled law that a fact, once decided in an earlier suit, is conclusively established between the parties [or their privies] in any later suit, provided it was necessary to the result in the first suit.") *Id.* at 293, 197 N.Y.S.2d at 133, *quoting* Judge Learned Hand in *The Evergreens v. Nunan*, 141 F.2d 927, 928 (2d Cir.), *cert. denied, Evergreens v. Commissioner of Internal Revenue*, 323 U. S. 720, 65 S.Ct. 49 (1944).

Neither the Bankruptcy Court nor the Solicitor General is empowered to alter the trial court's factual findings. The only issue presented to the Bankruptcy Court was a legal issue, that is, whether respondent's "co-opting [of the 50% owned corporate enterprise] for the benefit of the Hyman Agency [his 100% owned agency and] for his own personal enrichment" (92a), his exploitation of "the assets of NPS and NPA to obtain profits for himself" (90a) and his "misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS and NPA" (92a-93a), constituted a "defalcation" under Section 523(a)(4) of the Bankruptcy Code. No additional "evidentiary record" was required to determine this legal issue.

Finally, the notion that the state court proceeding was really about the respondent's failure to purchase the petitioner's 50% interest, as opposed to respondent's self-dealing, was first promoted in the Bankruptcy Court and seems to have gained limited currency with the Solicitor General. (SCB, p. 20, n. 9). As acknowledged by the Solicitor General, the trial court "did not find that respondent failed to negotiate in good faith or that the price he offered was unreasonably low." (*Id.*) Nor did the trial court find that he negotiated in good faith or that the offered price, if any, was adequate or excessive. The simple fact is that "failure to agree" was not in issue; it was never pleaded, briefed or argued in the state court proceeding, at trial or on appeal. To state the obvious, every civil trial, whether involving a pedestrian knock down or anti-trust violation, can be said to have resulted from the parties "failure to agree." Absent an obligation to do so, there is no such "cause of action" or "claim upon which relief may be granted." In the case at bar, neither party was under

an obligation to buy or to sell, and neither has ever contended otherwise. The contention is specious.

CONCLUSION

As the Solicitor General authoritatively demonstrates, "the term 'defalcation' in current Section 523(a)(4) is properly understood to encompass *all* cases in which a fiduciary diverts trust assets to his personal use . . . , even if the trustee acts without wrongful intent and sincerely believes that his conduct is proper." (SGB, p. 14) (emphasis in original)

The object of this appeal is to obtain a definitive ruling by this Court to that effect and obviate further conflicting and irreconcilable decisions among the circuit courts. If, notwithstanding the authorities cited by the Solicitor General, this Court were to conclude that "defalcation" does require "*some* level of scienter" (SGB, p. 18) (emphasis in original), we lose. The debate among the circuit courts regarding "the contours of that requirement" (*Id.*) can then proceed apace. In our view, the rule of *In re Hammond*, 98 F.2d 703 (2d Cir.) *cert. denied*, 305 U.S. 646, 59 S.Ct. 149 (1938), that no "conscious wrongdoing" is required in corporate fiduciary self-dealing cases would substantially end the ongoing "debate" and "confusion" which has existed for decades. To await the next petition for certiorari in this area, which may not come for decades more, would leave unresolved "issues . . . worthy of this Court's review" (SGB, p. 18) in an area "important to the administration of the bankruptcy laws." (*Id.*)

We urge the granting of our petition.

Dated: New York, New York
December 9, 2008

Respectfully submitted,

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AMICUS CURIAE BRIEF

No. 07-952

In the Supreme Court of the United States

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON, PETITIONER

v.

ANDREW A. HYMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTIONS PRESENTED

1. Whether the exception to discharge in bankruptcy established by 11 U.S.C. 523(a)(4), which applies to debts "for fraud or defalcation while acting in a fiduciary capacity," requires proof that the fiduciary either engaged in deliberate misbehavior or acted with extreme recklessness.

2. Whether, by virtue of collateral estoppel, the finding of the Surrogate's Court of New York that respondent breached his fiduciary duty and misappropriated assets compelled the bankruptcy court to hold that the debt created by the state court's judgment was for a "defalcation" within the meaning of Section 523(a)(4).

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In the Supreme Court of the United States

No. 07-952

G. HALLETT DENTON, AS EXECUTOR OF THE ESTATE OF GEORGE W. DENTON, PETITIONER

v.

ANDREW A. HYMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

This brief is filed in response to the order of this Court inviting the Solicitor General to express the views of the United States. In the view of the United States, the petition for a writ of certiorari should be denied.

STATEMENT

1. In 1987, respondent and George W. Denton formed an insurance agency, the Denton-Hyman Agency (Denton-Hyman), together with their own pension administration company, National Pension Service (NPS), and a third company, National Pension Actuaries (NPA). Pet. App. 3a-4a. Respondent and Denton each owned 50% of the companies, and each served as a director and executive officer. *Id.* at 4a.

Guardian Life Insurance Company (Guardian) designated Denton-Hyman as the company's agent for

Westchester County to market life insurance products through pension plans, with the proviso that the agency would terminate upon the departure of either from the business. Pet. App. 3a-4a. In starting their businesses, Denton and respondent had incurred debts in excess of $1.6 million, which they guaranteed jointly and severally. *Id.* at 4a. NPS channeled business to Denton-Hyman and operated at a loss. *Ibid.*

In 1989, G.W. Denton died and was succeeded by respondent as president and sole director of the three corporations. Denton's death terminated the agency relationship between Guardian and Denton-Hyman. Under Guardian's regulations, neither Denton's estate nor Denton-Hyman was eligible to be a shareholder in the new general agency. Pet. App. 4a.

Respondent thereafter became Guardian's agent, formed the Andrew A. Hyman Agency (Hyman Agency), and continued as before to operate NPS. Pet. App. 5a, 86a. As of 1994, when respondent's relationship with Guardian terminated, he had liquidated, with the estate's consent, the $1.6 million debt by using the residual jointly-owned Denton-Hyman commissions and the earnings of the Hyman Agency. *Id.* at 5a. At the same time, respondent conducted prolonged and difficult negotiations with the executor of the G.W. Denton estate, petitioner G. Hallet Denton, in an effort to purchase the estate's 50% interest in Denton-Hyman, NPS, and NPA. *Ibid.* The negotiations failed because the parties could not agree on what portion of the income that respondent generated belonged to him as opposed to the estate. *Ibid.*

Petitioner subsequently sued respondent in the Surrogate's Court of New York, asserting a shareholder derivative claim on behalf of Denton-Hyman. See Pet.

App. 5a, 84a. On December 31, 2002, the state court issued its decision. The court held that respondent owed a fiduciary duty to Denton-Hyman, NPS, and NPA arising out of his role as a 50% shareholder, officer, and director of the corporations. *Id.* at 92a. The court further held that respondent had breached that duty by "co-opting the Denton-Hyman, NPS and NPA enterprise for the benefit of the Hyman Agency and for his own personal enrichment," and that "[h]is actions constituted a misappropriation of the tangible assets and goodwill" of the three corporations. *Id.* at 92a-93a. The Surrogate's Court entered judgment in favor of the estate for $2,734,832, which reflected the net profits realized by respondent during the period that he operated the overall enterprise. *Id.* at 5a, 93a. The New York Supreme Court, Appellate Division, affirmed the judgment of the Surrogate's Court, *id.* at 47a, 106a-107a, and the New York Court of Appeals dismissed respondent's appeal as unripe, *id.* at 110a.

2. In February 2003, respondent filed for bankruptcy relief under chapter 11 of the Bankruptcy Code, 11 U.S.C. 1101 *et seq.* Pet. App. 6a, 47a. In July 2004, after the Surrogate Court's judgment in the state-court proceedings was affirmed by the Appellate Division, the bankruptcy case was converted to chapter 7, 11 U.S.C. 701 *et seq.* Pet. App. 47a.

Petitioner filed an adversary proceeding in the bankruptcy court, asserting a claim in the amount of the judgment of the Surrogate's Court. Pet. App. 6a, 47a. Petitioner contended that the debt created by that judgment was non-dischargeable because it arose from respondent's "defalcation while acting in a fiduciary capacity." *Id.* at 6a-7a; see 11 U.S.C. 523(a)(4) (establishing exception to bankruptcy discharge for any debt "for

fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny"). Petitioner waived his right to present evidence showing that the conduct on which the state court's judgment was premised constituted a "defalcation" within the meaning of Section 523(a)(4). Pet. App. 7a, 49a. Rather, petitioner relied on the doctrine of collateral estoppel to argue that the state court judgment established that respondent had engaged in a "defalcation." *Id.* at 7a, 42a-43a, 49a.

The bankruptcy court dismissed petitioner's claim. Pet. App. 39a-81a. The court held that "the Surrogate's Court Decision does not contain findings of fact and conclusions of law necessary to support denial of dischargability * * * under the doctrine of collateral estoppel." *Id.* at 81a. The court expressed the view that "[t]he word 'defalcation' used in subsection (4) * * * is far narrower than the concept of 'misappropriation' under state law," which includes "acts or omissions * * * done innocently or in good faith based upon mistake or negligence or simply disagreement between the parties as to their rights and obligations, with no conscious knowledge of or intent to do wrong." *Id.* at 61a. The court concluded that, "[g]iven the material differences between the meaning of 'defalcation' under federal bankruptcy law and the concepts of misappropriation and breach of fiduciary duty under state law, it simply cannot be said that the federal question at issue * * * was considered and decided in the Surrogate's Court proceeding." *Id.* at 67a-68a.

3. The district court affirmed the decision of the bankruptcy court. Pet. App. 20a-38a. The court held that "[d]efalcation requires more than mere negligence and cannot be a completely innocent act." *Id.* at 34a (quoting *Zohlman* v. *Zoldan*, 226 B.R. 767, 777

(S.D.N.Y. 1998)). The district court concluded that the "[c]reditor's reliance on the state court's characterization of Debtor's conduct as 'co-option,' 'misappropriation' and 'exploitation' of corporate assets does not persuade this Court that the issue of 'defalcation,' as that term is interpreted under the Bankruptcy Code, was previously decided." *Id.* at 29a.

4. The court of appeals affirmed. Pet. App. 1a-19a. In deciding whether the findings of the state court should be given preclusive effect, the court observed that "[t]he first critical question is whether a 'defalcation while acting in a fiduciary capacity' under [Section] 523(a)(4) of the Bankruptcy Code is identical to the factual and legal determinations necessarily decided in the prior Surrogate's Court action." *Id.* at 9a-10a. The court further noted that "[t]here has been much debate among the Circuits over whether a 'defalcation' under § 523(a)(4) includes all misappropriations or failures to account or only those that evince some wrongful conduct." *Id.* at 10a-11a. The court "align[ed] [itself] with the First Circuit * * * in holding that defalcation * * * requires a showing of conscious misbehavior or extreme recklessness—a showing akin to the showing required for scienter in the security law context." *Id.* at 15a (citing *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002)). The court rejected the decisions of other courts of appeals holding that a fiduciary's innocent mistake can sometimes constitute a "defalcation." *Id.* at 13a. The court explained that, under the standard it adopted, Section 523(a)(4) "does not reach fiduciaries who may have failed to account for funds or property for which they were responsible only as a consequence of negligence, inadvertence or similar conduct not shown to be sufficiently culpable." *Id.* at 16a.

The court of appeals held that the doctrine of collateral estoppel was inapplicable in this case because the decision of the Surrogate's Court did not establish the elements of "defalcation" under Section 523(a)(4). Pet. App. 16a-18a. The court explained that the state court had "made no express findings with regard to [respondent's] state of mind," and that "the record contain[ed] evidence of [respondent's] good faith." *Id.* at 16a, 17a. Noting that "[t]he Surrogate had neither the ability nor the incentive to apply the standard we announce," *id.* at 17a, the court of appeals stated that it was "loath to conclude that an identical issue was necessarily decided or that [respondent] had a full and fair opportunity to contest his state of mind," *id.* at 18a.

DISCUSSION

Questions concerning the state of mind required for "defalcation" under 11 U.S.C. 523(a)(4) have arisen frequently and have divided the court of appeals. By categorically holding that Section 523(a)(4) "requires a showing of conscious behavior or extreme recklessness," Pet. App. 15a, the court of appeals construed the term "defalcation" in a way that conflicts with its common usage at the time that Section 523(a)(4)'s statutory predecessors were enacted, and with the holdings of other circuits. At least in circumstances where the relevant breach of duty is a wrongful diversion of trust assets to the fiduciary's own use or to another unauthorized purpose, the breach is properly regarded as a "defalcation" within the meaning of Section 523(a)(4), regardless of whether the fiduciary acts with ill intent.

This case, however, is not an attractive vehicle for the Court to clarify the precise meaning of the term "defalcation" or the proper application of Section 523(a)(4)

to the most frequently recurring factual scenarios. Petitioner did not seek to introduce evidence of respondent's wrongdoing in the bankruptcy court, but rather relied solely on the purported collateral estoppel effect of a state-court decision that contained no findings as to respondent's intent. If this Court granted certiorari and rejected petitioner's contention that *no* showing of scienter is needed to establish a "defalcation" within the meaning of Section 523(a)(4), the Court would have no occasion to decide what level of scienter *is* required. Moreover, under a proper understanding of Section 523(a)(4), the level of scienter needed to establish a "defalcation" will vary depending on the nature of the fiduciary breach involved. Because the circumstances of this case are unusual, the Court's application of Section 523(a)(4) to these facts is unlikely to provide guidance as to the statute's proper application to more common fact patterns.

On balance, while the question presented is important and subject to a circuit split, the Court should wait and address the meaning of the term "defalcation" and the proper application of Section 523(a)(4) in a case that would permit the Court fully to expound on what standard of scienter is required and how it applies in more common fact patterns. Accordingly, the petition should be denied.

A. The Court Of Appeals Erred In Categorically Holding That Proof Of Deliberate Misbehavior Or Extreme Recklessness Is Required To Establish A "Defalcation" Within The Meaning Of 11 U.S.C. 523(a)(4)

1. Section 523(a)(4) of the Bankruptcy Code provides in pertinent part:

> (a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
>
> * * * * *
>
> (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.

11 U.S.C. 523(a)(4).[1] The term "defalcation" is not defined in the Code but has a long history of pre-Code use in the bankruptcy laws.

The 1841 Bankruptcy Act established a system of bankruptcy applicable to "[a]ll persons whatsoever * * * owing debts, which shall not have been created in consequence of defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity." Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441; see *Central Hanover Bank & Trust Co.* v. *Herbst*, 93 F.2d 510, 511 (2d Cir. 1937) (L. Hand, J.). At that time, the ordinary dictionary definition of the term "defalcation" contained no scienter requirement. See, *e.g.*, Samuel Johnson, *A Dictionary of the English Language* 6L (1755) ("diminution; abatement; excision of any part of a customary allowance"); Noah Webster, *An American Dictionary of the English Language* 56 (1828) ("The act of cutting off, or deducting a part; deduction; diminution: abatement; as, let him have the amount of his rent without *defalcation*."). Legal dictionaries from the nineteenth century and early-

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[1] Section 523(a)(11) of the Bankruptcy Code similarly exempts from discharge debts created by certain judgments, orders, or settlements "arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. 523(a)(11).

twentieth century similarly embraced a meaning of defalcation that was not limited to a fiduciary's intentional wrongdoing.[2]

Judicial decisions issued during the relevant period likewise did not suggest that any particular mental state was an essential prerequisite to a "defalcation." Before 1841, courts used the term "defalcation" in several contexts. A public officer's failure to account for and pay over to the government funds he received was described as a "defalcation," often without discussing whether the officer acted with a bad intention.[3] The term was also commonly used to describe a fiduciary, such as an executor of an estate, a guardian, or a trustee, who appropriated funds for his own use rather than protecting them

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[2] One meaning was simply "the act of a defaulter." John Bouvier, *A Law Dictionary* 388 (6th ed. 1856). In turn, a "defaulter" could be "[o]ne who is deficient in his accounts, or fails in making his accounts correct." *Ibid.*; Stewart Rapalje & Robert L. Lawrence, *A Dictionary of American and English Law* 362 (1888) (A "defaulter" is "[o]ne who makes a default," which is "[t]he neglect or non-performance of a duty.").

[3] See, *e.g.*, *Smith* v. *United States*, 30 U.S. (5 Pet.) 292, 298-299 (1831) (paymaster who failed to pay over funds upon his retirement found by jury to be liable for "defalcation" even though he claimed to have paid over all funds); see *Thompson* v. *Ross*, 24 Ky. (1 J.J. Marsh.) 600, 602 (1829); see also *Duncan's Heirs* v. *United States*, 32 U.S. (7 Pet.) 435, 446-447 (1833); *United States* v. *Nicholl*, 25 U.S. (12 Wheat.) 505, 508 (1827); *Postmaster Gen.* v. *Norvell*, 19 F. Cas. 1103 (E.D. Pa. 1829) (No. 11,310); *Salling* v. *M'Kinney*, 28 Va. (1 Leigh) 42 (1829). Some decisions made clear that the officer had failed to pay over the funds precisely because he had embezzled them. *E.g.*, *Baker* v. *Preston*, 21 Va. (Gilmer) 235, 287 (1821) (describing state treasurer's embezzlement as "defalcation"), overruled in part, *United States Fid. & Guar. Co.* v. *Jordan*, 58 S.E. 567 (Va. 1907). Those decisions did not hold, however, that an intent to make wrongful use of trust assets was essential to a finding that a "defalcation" had occurred.

for the estate, ward, or trust.[4] The word "defalcation" was also used in the early 1800's to describe garden variety acts of embezzlement, typically by a bank cashier.[5]

Consistent with those decisions, this Court remarked, shortly after the passage of the 1841 Act, that the "defalcation" exception to the rule of dischargeability covers "[a] misapplication of trust funds" and "fiduciary debts." *Chapman* v. *Forsyth*, 43 U.S. (2 How.) 202, 207-208 (1844).[6] Lower courts likewise understood the term "defalcation" under the 1841 Act to encompass a fiduciary's use of funds for an unauthorized

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[4] *E.g.*, *Bunting* v. *Ricks*, 22 N.C. (2 Dev. & Bat. Eq.) 130 (1838) (use of entrusted security for own purposes); *Deaderick* v. *Cantrell*, 18 Tenn. (10 Yer.) 263 (1837) (executor's use of estate funds for own purposes). But see *Brazer* v. *Clark*, 22 Mass. (5 Pick.) 96, 108 (1827) (Executor's liability for late sale of stock resulting in obtaining less than half of earlier price described as a "defalcation," and implied that it could result from "negligence or fraud.").

[5] *Taylor* v. *Bank of Ky.*, 25 Ky. (2 J.J. Marsh.) 564 (1829); *Henderson* v. *Morgan*, 4 Mart. (n.s.) 649 (La. 1826) (bank cashier's embezzlement a "defalcation"); *President of Dedham Bank* v. *Chickering*, 21 Mass. (4 Pick.) 314, 352 (1826) (bank clerk absconded with funds, described as "defalcation").

[6] In *Chapman*, this Court held that, under Section 1 of the 1841 Act, a debtor could obtain discharge of non-fiduciary debts even though he also owed debts that were non-dischargeable because they were incurred through a defalcation as a public officer or trustee. 43 U.S. (2 How.) at 207-208. The Court explained that the exception to dischargeability stated in Section 1 "applies to the debts and not to the person, if he owe other debts." *Id.* at 207. The Court contrasted Section 1 of the 1841 Act with Section 4, which provided that discharge in bankruptcy was not available to "any person who, after the passing of this act, shall apply trust funds to his own use." 5 Stat. 444. The Court explained that, "whilst the first section only withholds from the jurisdiction of the bankrupt court fiduciary debts, the fourth declares that if such debts have been contracted subsequent to the law, the individuals shall not be discharged." *Chapman*, 43 U.S. (2 How.) at 208.

purpose, without regard to the fiduciary's subjective intentions in making the expenditure. See, *e.g.*, *Pinkston* v. *Brewster, Solomon & Co.*, 14 Ala. 315, 322-323 (1848) (trustee commits a defalcation when he pays only one creditor contrary to his obligation to pay creditors pro rata); *Flagg* v. *Ely*, 1 Edm. Sel. Cas. 206, 208-209 (N.Y. Sup. Ct. 1846) (following *Chapman* and stating "that good faith forbid[s] the appropriation of the [trust] money to any other than the specified purpose"). Judicial precedent thus strongly suggests that proof of a "defalcation" within the meaning of the 1841 Act did not categorically require the "showing of conscious misbehavior or extreme recklessness," Pet. App. 15a, that the court of appeals held is essential under current law.

That conclusion is reinforced by Section 4 of the 1841 Act, which rendered ineligible for discharge in bankruptcy "any person who, after the passing of this act, shall apply trust funds to his own use." 5 Stat. 444. Section 4 contained no express scienter requirement but rather applied by its terms to an individual who made personal use of trust assets based on a sincere but incorrect belief that he was entitled to the money. Section 4, moreover, entailed more onerous consequences than did Section 1, since individuals covered by Section 4 were wholly ineligible for discharge in bankruptcy even with respect to non-fiduciary debts. See note 6, *supra*. The natural reading of the two provisions taken together is that a trustee's diversion of trust funds to his own use was a Section 1 "defalcation" without regard to the trustee's intent. Consistent with that reading, the Court in *Chapman* noted that "[a] misapplication of trust-

funds * * * covers the enumerated cases in the first section." 43 U.S. (2 How.) at 207-208.[7]

2. In 1867, Congress enacted a bankruptcy law that rendered non-dischargeable any "debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533; see *Herbst*, 93 F.2d at 511. Courts continued to recognize that a public officer's failure to pay over taxes that he received was a defalcation under the bankruptcy laws. *Grantham* v. *Clark*, 62 N.H. 426, 427 (1882); *Councill* v. *Horton*, 88 N.C. 222, 223 (1883). One court concluded that a "defalcation" does not occur when a public officer fails to pay over tax money because of a purportedly negligent failure to collect the funds. *Courtney* v. *Beale*, 5 S.E. 708, 709-710 (Va. 1888). The court in that case explained that a "defalcation" requires "*mala fides*," and that the term has been defined as "the failure of one who *has received money* in trust or in a fiduciary capacity to account and pay over as he ought." *Ibid.* The court concluded "that the liability of a public officer created by his negligence merely,—as, for exam-

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[7] In explaining the relationship between Sections 1 and 4 of the 1841 Act, the Court in *Chapman* also stated that, "whilst the first section only withholds from the jurisdiction of the bankrupt court fiduciary debts, the fourth declares that if such debts have been contracted subsequent to the law, the individuals shall not be discharged." 43 U.S. (2 How.) at 208. That statement strongly suggests that all debts identified in Section 4 (*i.e.*, debts arising out of a fiduciary's application of trust funds to his own use) were also encompassed by Section 1—a proposition that would not be true if proof of "defalcation" required evidence of wrongful intent.

ple, in failing to use due diligence in collecting and paying over money,—is not a defalcation." *Id.* at 710.[8]

In 1898, Congress rendered non-dischargeable debts "created by [the bankrupt's] fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-551. Some courts concluded that any failure of a fiduciary to account for trust funds is a defalcation. See, *e.g.*, *First Citizens Bank & Trust Co.* v. *Parker*, 35 S.E.2d 489, 492 (N.C. 1945); *Citizens Mut. Auto. Ins. Co.* v. *Gardner*, 24 N.W.2d 410, 413 (Mich. 1946); *Orndorff* v. *State*, 108 S.W.2d 206, 212 (Tex. Civ. App. 1937); *England Loan Co.* v. *Campbell*, 35 S.W.2d 75, 78 (Ark. 1931); cf. *National Sur. Co.* v. *Wittich*, 240 N.W. 888, 889 (Minn. 1932) (failure to account for and pay over funds coming into bankrupt's control is prima facie defalcation or misappropriation). Other courts stated or suggested that some form of misconduct was required. See, *e.g.*, *Aetna Cas. & Sur. Co.* v. *Lauerman*, 107 N.W.2d 605, 609 (Wis. 1961); *Western Sur. Co.* v. *Reed*, 447 P.2d 672, 673 (N.M. 1968). Some of the cases requiring misconduct appeared to recognize, however, that a failure to account for funds received as a fiduciary is itself misconduct. *Indemnity Ins. Co. of N. Am.* v.

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[8] Read in isolation, the court's references in *Courtney* to the need for "*mala fides*" and the insufficiency of negligence standing alone might suggest that proof of heightened scienter is necessary to establish a "defalcation." The court's decision ultimately appears to rest, however, on the distinction between (a) wrongful payment of (or failure to account for) monies *actually received*, and (b) negligent failure to collect funds that ought to have been paid into the relevant account. The court in *Councill*, by contrast, held that an officer charged with collecting taxes had committed a "defalcation" based on proof that the taxes were "either not collected or collected and not paid over by him." 88 N.C. at 223.

Leibrock, 55 N.Y.S.2d 3, 4 (Sup. Ct. 1945); *Western Sur. Co.*, 447 P.2d at 673.

3. In 1978, Congress replaced the 1898 provision with 11 U.S.C. 523(a)(4). The legislative history of the 1978 Bankruptcy Code revision does not indicate an intent to change the meaning of the term "defalcation." *In re Hayes*, 183 F.3d 162, 168 (2d Cir. 1999); *Meyer* v. *Rigdon*, 36 F.3d 1375, 1382-1383 (7th Cir. 1994); *In re Cross*, 666 F.2d 873, 882 n.14 (5th Cir. 1982). There similarly is no indication that the 1898 law was intended to change the meaning of "defalcation" as that term was used in earlier bankruptcy laws. *Crawford* v. *Burke*, 195 U.S. 176, 192 (1904). Accordingly, the meaning of the term as it appeared in pre-Code bankruptcy laws is a significant factor in determining Congress's intent. *Cohen* v. *de la Cruz*, 523 U.S. 213, 221 (1998); see *Director, OWCP* v. *Greenwich Colleries*, 512 U.S. 267, 275 (1994); *Nationwide Mut. Ins. Co.* v. *Darden*, 503 U.S. 318, 322 (1992).

In light of the history described above, the term "defalcation" in current Section 523(a)(4) is properly understood to encompass *all* cases in which a fiduciary diverts trust assets to his personal use or to another unauthorized purpose, even if the trustee acts without wrongful intent and sincerely believes that his conduct is proper. That view is consistent with the common understanding of the term "defalcation" in 1841 and at the time of subsequent bankruptcy laws. It also strikes an appropriate balance between the "fresh start" policy that animates the bankruptcy laws generally, see *Marrama* v. *Citizens Bank*, 127 S. Ct. 1105, 1107 (2007), and the recognition (reflected in Section 523(a)'s exceptions) that some debts by their nature are unsuitable for discharge.

Even if a fiduciary does not engage in fraud or intentional wrongdoing, his use of trust property for other than its intended purpose constitutes serious misconduct. The equitable arguments against discharge in this setting are particularly compelling if the fiduciary diverts trust assets to his *own* use, thereby enriching himself even as the trust is diminished. As explained, under Section 4 of the 1841 Act, trustees who engaged in such conduct were categorically ineligible for discharge in bankruptcy even as to their non-fiduciary debts.

This does not mean that *every* breach of fiduciary duty constitutes a "defalcation" or that Section 523(a)(4) never requires proof of scienter. Many fiduciary breaches, such as a failure to exercise due care in selecting prudent investments or in managing income-producing properties, do not involve a diversion of trust assets to unauthorized purposes. Such breaches are not obviously encompassed by 1841-era dictionary definitions of the term "defalcation" (see p. 8, *supra*), and they are relatively far afield from the core breach of trust (application of trust assets to the fiduciary's personal use) described in Section 4 of the 1841 Act. Under Section 523(a)(4), proof of wrongful intent or recklessness may therefore be necessary to preclude discharge of debts arising from breaches of that character.

The approach described above is consistent with Judge Learned Hand's opinion for the Second Circuit in *Herbst*, which has been described as "the most authoritative explication" of the term "defalcation" as it appears in the bankruptcy laws. *In re Hayes*, 183 F.3d at 171. In *Herbst*, an individual was appointed receiver of real property in a foreclosure suit and was awarded $5,674.54 by the trial court after the property was sold. 93 F.2d at 511. He spent the money without attempting

to ascertain whether the award would be appealed, and he declared bankruptcy after the state appellate court disallowed the award. *Ibid.* Without purporting to decide the scope of the term "defalcation" in other circumstances, the Second Circuit held that "when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a 'defalcation' though it may not be a 'fraud,' or an 'embezzlement,' or perhaps not even a 'misappropriation.'" *Id.* at 512. The court in *Herbst* did not hold that the receiver (who had received the funds pursuant to the state trial court's order) had acted recklessly or with wrongful intent; rather, the court found it sufficient that the receiver had taken and spent the money with actual or constructive knowledge that the award was subject to possible reversal on appeal. See *ibid.* That decision supports the view that, at least where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized, a Section 523(a)(4) "defalcation" occurs regardless of the fiduciary's state of mind.

B. The Courts Of Appeals Are Divided Over The Meaning Of The Term "Defalcation"

As the court of appeals recognized, the circuits are divided over the level of intent required by the term "defalcation" under Section 523(a)(4). Pet. App. 11a-14a. Other courts similarly have recognized the split in the circuits on the issue. *In re Baylis*, 313 F.3d at 18; *Meyer*, 36 F.3d at 1383. "Roughly, three interpretive camps have been established as to the standard for measuring defalcation." *In re Baylis*, 313 F.3d at 18.

The Second Circuit in this case aligned itself with the First Circuit, which has "set the highest bar," requiring

a showing of conscious misbehavior or extreme recklessness, "akin to the level of recklessness required for scienter [in securities law]." Pet. App. 14a (quoting *In re Baylis*, 313 F.3d at 20). By contrast, the Fourth, Eighth, and Ninth Circuits have rejected the view that Section 523(a)(4)'s "defalcation" exception to dischargeability always requires proof of intentional wrongdoing. Consistent with the position set forth above, pp. 14-15, *supra*, those courts have held that the term covers innocent or negligent actions of a fiduciary where those actions result in misappropriation or failure to account for assets held in trust. *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001); *In re Hemmeter*, 242 F.3d 1186, 1190 (9th Cir. 2001); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997), cert. denied, 522 U.S. 1112 (1998).

Finally, the Sixth and Seventh Circuits have held that, although a breach of duty resulting from the fiduciary's negligence or mistake *of fact* is not encompassed by Section 523(a)(4), a "defalcation" does occur if the fiduciary knowingly uses trust funds for a purpose that is in fact unauthorized, even if he does not intend to violate a known fiduciary duty (*i.e.*, if the fiduciary's mistake of law leads him to believe that an unauthorized purpose is authorized). *Meyer*, 36 F.3d at 1384-1385; *In re Johnson*, 691 F.2d 249, 257 (6th Cir. 1982).

C. This Case Is Not An Attractive Vehicle For This Court To Decide The Level Of Intent Required For A Defalcation

As explained above, the Second Circuit erred in categorically holding that "defalcation under § 523(a)(4) requires a showing of conscious misbehavior or extreme recklessness." Pet. App. 15a. Questions concerning the meaning of the term "defalcation" have arisen fre-

quently and have divided the courts of appeals, and their proper resolution is important to the administration of the bankruptcy laws. The issues are accordingly worthy of this Court's review in an appropriate case. For three related reasons, however, this case does not present an attractive vehicle for this Court to clarify the proof required to establish a Section 523(a)(4) "defalcation."

1. In the bankruptcy court, petitioner waived his right to present evidence showing that respondent's debt to him arose from a "defalcation" within the meaning of Section 523(a)(4). Rather, petitioner relied on the doctrine of collateral estoppel, arguing that the *findings* of the Surrogate's Court in the prior proceeding encompassed all findings necessary to establish that a "defalcation" had occurred. See Pet. App. 42a-43a, 49a. The question actually before the Surrogate's Court, however, was not whether respondent had committed a Section 523(a)(4) "defalcation," but whether he had committed a state-law breach of fiduciary duty. Thus, in neither the federal nor the state proceedings did the parties create an evidentiary record focused upon the bankruptcy-law question presented in this case.

2. As the court of appeals emphasized, the Surrogate's Court "made no express findings with respect to [respondent's] state of mind." Pet. App. 16a. If this Court granted certiorari and ultimately held that proof of a Section 523(a)(4) "defalcation" requires *some* level of scienter under the circumstances of this case, the Court therefore would have no occasion to identify the precise mental state that is required. The courts of appeals that have recognized a scienter requirement in this context have divided as to the contours of that requirement, see *id.* at 13a-14a; see pp. 16-17, *supra*, and that circuit conflict might remain even if this Court granted

certiorari here. It would be preferable for the Court to grant certiorari in a case where the Court could resolve that disagreement on a concrete record, if the Court concludes that some level of scienter is required.

3. Perhaps most significantly, the Surrogate's Court's finding of a fiduciary breach arose out of very idiosyncratic circumstances, and this Court's application of Section 523(a)(4) in this case might ultimately shed little light on the meaning of "defalcation" in more typical factual settings. Although the Surrogate's Court described respondent's conduct as a "misappropriation of the tangible assets and goodwill of Denton-Hyman, NPS, and NPA," Pet. App. 92a-93a, no finding was made that respondent divested those corporations of their property. See *id.* at 68a (Bankruptcy court observes that "[t]here is no finding of fact by the Surrogate, and no claim by [petitioner] in this adversary proceeding, that [respondent] took money or property of the Denton-Hyman Agency, NPS or NPA without accounting for it.") (emphasis omitted).

The Surrogate's Court's finding that corporate assets were "misappropriat[ed]" rests on respondent's decision to operate the overall enterprise in a way that predictably resulted in profits for the Hyman Agency and losses for NPS. See Pet. App. 87a, 92a-93a. That mode of operation was fully consistent, however, with the manner in which the business had previously been conducted. See *id.* at 86a (Surrogate's Court observes that, "[i]n effect, nothing changed, with the singular exception that premiums earned on the sale of Guardian products were paid to the Hyman Agency, not to Denton-Hyman"); *id.* at 89a (explaining that, even before G.W. Denton's death, "NPS and NPA were not profit centers" and "both consistently lost money" in order "to provide

revenue for the general agency"). The Surrogate's Court apparently concluded that this longstanding practice became improper after Denton-Hyman was replaced by the Hyman Agency and the various components of the enterprise ceased to be under common ownership.[9]

Under principles of collateral estoppel, the state court's decision is binding on the question whether respondent's conduct constituted a breach of fiduciary duty under New York law. But if the level of scienter required to establish a Section 523(a)(4) "defalcation" varies depending on the nature of the fiduciary breach involved (see pp. 14-16, *supra*), the Surrogate's Court's mere use of the term "misappropriation" cannot control the bankruptcy-law inquiry. The breach found by the state court in this case is both difficult to categorize and relatively far afield from the typical diversion of trust assets to unauthorized purposes. Thus, this case does not offer an opportunity to provide guidance on the ap-

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[9] The Surrogate's Court suggested that the manner in which respondent operated the overall enterprise might have been lawful if a portion of the Hyman Agency's commissions had been shared with or assigned to the G.W. Denton estate. See Pet. App. 90a-91a; *id.* at 93a ("The use of NPS and NPA as feeders of new business for the Hyman Agency *without compensation* constitutes a breach of fiduciary duty to the corporations.") (emphasis added). Respondent did, however, engage in prolonged negotiations to purchase the estate's 50% interest in Denton-Hyman, NPS, and NPA. See *id.* at 5a. The Surrogate's Court did not find that respondent failed to negotiate in good faith or that the price he offered was unreasonably low. And, to the extent that the state-law breach found by the Surrogate's Court lay in respondent's failure to compensate the estate, there is a significant question whether respondent committed that breach "while acting in a fiduciary capacity" within the meaning of Section 523(a)(4). See *id.* at 78a-79a (bankruptcy court opinion); Br. in Opp. 10.

plication of Section 523(a)(4) and the meaning of "defalcation" in more usual cases.

Accordingly, while the proper application of Section 523(a)(4) and meaning of "defalcation" is important and has divided the courts of apples, on balance this case does not provide an attractive vehicle for the Court to resolve that circuit split and provide needed guidance on that issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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